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Summer 1986

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The Need for a Better Budget Process

Alice M. Rivlin

THE TIME has come to simplify the federal budget process. Hardly anyone likes the complicated and arcane procedure the U.S. government uses to arrive at a budget. The process consumes enormous amounts of executive branch and congressional time and even then is rarely completed. Deadlines are missed, and government agencies frequently run on "continuing resolutions" rather than regular appropriations. Occasionally a president makes a show of closing down the government for a few hours because agreement has not been reached on further funding.

Frustrated with continuing budget deficits and their inability to reduce them, Congress and the president agreed in the fall of 1985 on the Balanced Budget and Emergency Deficit Control Act, better known as the Gramm-Rudman-Hollings law. The law, which set up a mechanism to balance the budget in five years, was enacted in desperation to break the deadlock between Congress and the president and reduce the deficit, but not even its staunchest defenders regard it as a desirable process for making a budget. Whether or not this desperate gamble will work to cut the deficit, the question remains: what can be done to improve the budget process?

A drastic simplification is in order. Most spending decisions should be made for two or more years at a time, and possibly the whole budget should be shifted to a biennial basis. Congressional committees should be restructured to combine the authorization and appropriation functions. The budget itself should be simplified and the number of line items greatly reduced, actions that would help shift congressional attention toward major policy issues and away from detailed micro-management. As for the Gramm-Rudman-Hollings law, I share the hope that it will hasten agreement on deficit reduction but regard it as a bad budget process. Constraining the budget deficit to a particular number — whether by law or constitutional amendment — risks destabilizing the economy.

Why Making a Federal Budget Is So Hard

Making the budget process simpler and more comprehensible, however, would not make the decisions easier. Budget-making is inherently difficult for any organization, whether it be a family, a business, a university, or a government. There are never enough resources to carry out all desired activities. Choices have to be made, and these choices often bring to the surface deeply divergent views about the organization's purpose, how that purpose should be carried out, and who should bear the burdens or reap the benefits. Nevertheless, most organizations do manage to make budgets and live with them. Why is the U.S. government experiencing such agonizing difficulty?

Four conditions can make it especially difficult for an organization to agree on

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a budget. First, it is harder to make a budget when there are lots of choices regarding both income and spending. Poor families have to eat and pay the rent; poor governments have to defend the borders and deliver the mail. Neither has many choices. Life is easier for families and governments with more earnings and sources of revenue, but budget choices get more complicated.

Second, budget-making is more complex when the organization has access to credit. Without credit families would be far less adequately housed and equipped, businesses would find it hard to function, states and localities would forgo building needed facilities. If it were unable to borrow, the federal government would be forced to raise taxes or cut spending during recessions, making swings in the economy much wider. But governments, like families and businesses, can over-borrow, and the question of how much to borrow or pay back makes budgeting more complicated and contentious.

Third, variations in prices, employment, incomes, and responsibilities make it difficult for any organization to estimate future costs and revenues and reach decisions about them. Finally, and most important, budget-making is hard when the organization has multiple decision-makers with different convictions about what the organization ought to do and how it ought to do it. The situation requires a budget process — a procedure for arraying choices, debating what should be done, and making decisions.

The U.S. government is subject to all of these budget-complicating conditions in extreme form. It has the taxing capacity of a wealthy country and faces a high level of world and domestic responsibilities. It has apparently unlimited access to credit and has experienced the uncertainties about costs and revenues associated with wide swings in prices and economic activity and with unexpected world events. But most important is the decision-making complexity inherent in the constitutional separation of powers between Congress and the president. The president can propose changes in budgetary priorities, but the ultimate power to levy taxes and authorize spending of public funds is lodged in Congress, subject only to presidential veto. This divided rule works well when the president and Congress are in broad agreement or are willing to compromise their differences. It leads to deadlock and frustration when congressional and presidential views differ and one or both are unwilling to strike a bargain. Recent deficits have reflected the collision between the president's unwillingness to increase taxes or reduce defense growth and Congress's refusal to cut domestic spending by the amounts or in the ways proposed by the president.

One can imagine a contentious family with differing views on how to reduce its budget deficit arriving at a procedure like Gramm-Rudman-Hollings. First, some members might argue that the deficit is temporary and the family will "grow out of it"; others that the deficit does not matter. Gradually all realize that they are facing a permanent and potentially damaging gap between expected spending and expected revenues and that debt and interest payments are rising rapidly. Members of the family propose different plans for adjusting spending and revenues and are unwilling to compromise. Finally, someone suggests that all spending be cut by a fixed percentage until balance is restored. But some expenditures — the mortgage, car payments — cannot feasibly be reduced, so these are exempted.

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The percentage by which the remaining items must be cut to meet the target then rises. Everyone recognizes that this is an undesirable way to make budget decisions, but they are so desperate to reduce the deficit that they agree that the formula cuts will automatically come into effect on a specific date if they cannot settle on a more satisfactory way of reducing the deficit in the interim. This is how the U.S. "family" adopted Gramm-Rudman-Hollings.

Evolution of the Process

Surprisingly, despite all the talk about the budget and the budget process, no budget for the U.S. government is ever actually enacted as such. Government spending and revenue in any one year result from the application of a large number of separate laws enacted at different times that specify how the government can raise and spend money. The elaborate set of documents labeled *The Budget of the United States Government*, which the president issues with such fanfare each year, is really a set of proposals, detailed estimates of what will be spent and collected in the next year if the president's recommendations for spending and taxing laws are accepted by Congress and the economy behaves as the administration assumes (or hopes) it will.

Because of the separation of powers, the history of budget-making in the U.S. government is two separate histories: that of executive branch efforts to evolve a procedure for crafting the president's budget proposals and that of congressional efforts to make spending and taxing decisions in a more orderly way. Gramm-Rudman-Hollings is unique because it tries for the first time to deal with the efforts simultaneously and create a procedure for forcing the president and Congress to attain an agreed budget deficit target *together*. It is not yet clear whether this objective can be achieved in a way that does not violate the constitutional separation of powers.

The President's Budget

The U.S. government had no budget decision process at all until after World War I. Throughout the nineteenth and early twentieth centuries, the central government had few budget responsibilities, and government agencies took their requests for funds directly to Congress.

The Budget and Accounting Act of 1921 represented a major departure from these practices: it was the first in a series of institutional changes designed to make sure the president controlled requests for funds and proposed a budget that reflected the views and priorities of his administration. The act created a new staff, now called the Office of Management and Budget, charged with examining the requests of agencies and providing the president with the information on which to base budget proposals.

Subsequently, the Employment Act of 1946 charged the newly created Council of Economic Advisers with responsibility for forecasting economic developments, assisting the president in formulating fiscal policy, and making an annual economic report to Congress. In the 1960s and 1970s the executive branch attempted to improve the systematic evaluation of government programs, to look further into the future at needs for government action, to estimate the costs, benefits, and distributional effects of alternative spending or taxing programs, and to put the budget decision-making process on a firm schedule.

Thus by the early 1970s the executive branch of the government had institutionalized budget-making. The president was well equipped to translate his political predilections into budget proposals. But the result of all this executive activity was just a set of proposals. Congress was responsible for making the ultimate budget decisions.

The Congressional Process

Unlike the executive branch, by the 1970s Congress had evolved no comparably centralized institutions. Before 1974 no committee had legislative responsibility for budget policy as a whole. Many spending decisions were made in two stages. First, legislative committees worked on bills authorizing spending for particular programs. Even after such bills were passed by both houses and signed by the president, no money could be spent until separate appropriations bills made their way through another set of committees in both houses and were approved and signed into law. More than a dozen major appropriations bills were voted on at different times of the year. Relative priorities, such as defense as opposed to education or health, were never explicitly considered.

Spending for social insurance and other entitlement programs, which was growing rapidly in the 1960s and 1970s, remained outside the normal appropriations process. Amounts spent on these programs were determined automatically once the characteristics of beneficiaries and the level of their benefits were defined by legislation.

Revenue bills came out of different committees and were voted on separately from spending measures. Because the spending and taxing sides were never brought together, Congress never voted on the question whether revenues and expenditures were in appropriate relationship to each other. Congressional budget policy was the accidental result of spending and revenue decisions influenced by different committees and made at different times.

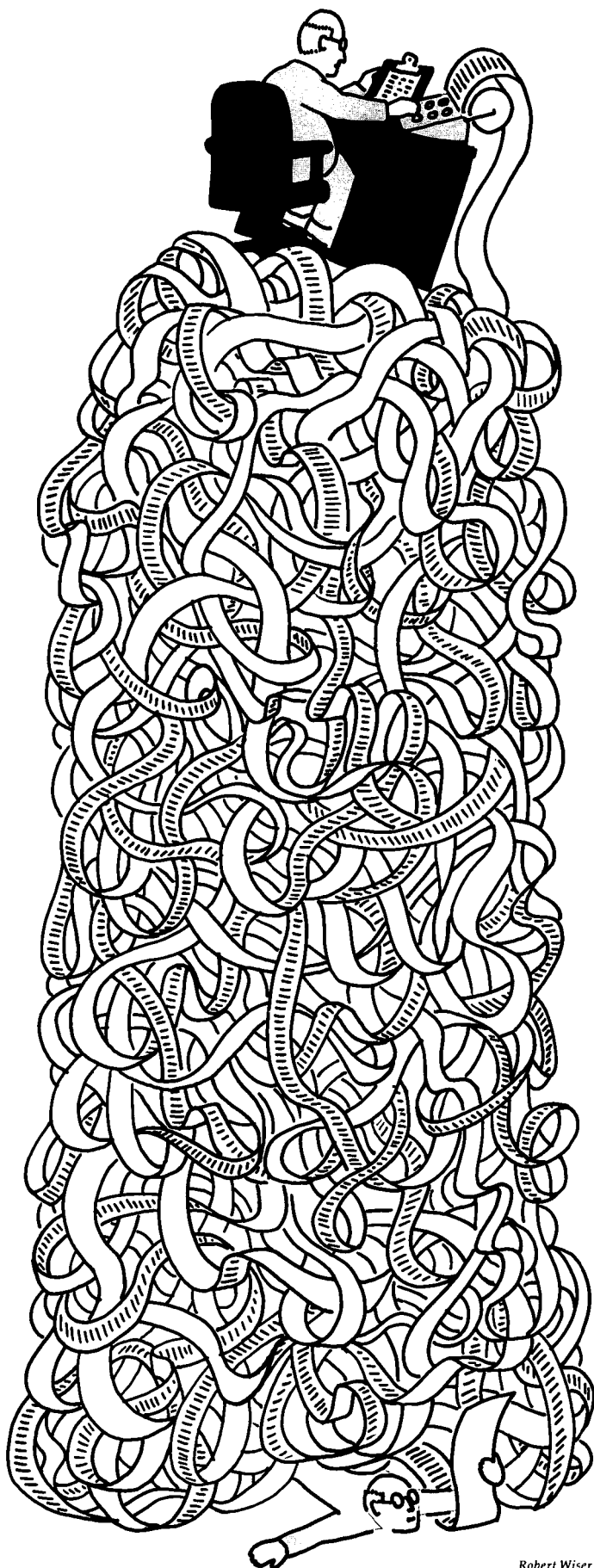
Spurred by feelings of frustration and impotence in confronting President Nixon, whose priorities differed from their own, members of Congress finally took a long overdue step and passed the Congressional Budget Act of 1974. The act created budget committees in each house charged with formulating an overall budget policy that, when passed by Congress in the form of a budget resolution, would serve as a controlling framework within which individual taxing and spending measures could be fitted. It also created the Congressional Budget Office to give Congress an objective, nonpartisan source of budget analysis and information.

The budget act provided for an elaborate three-stage process spread over a nine-month period between January, when the president's budget proposal is made, and October 1, when the new fiscal year begins. In the first stage the budget committees would produce a first concurrent resolution on the budget that would specify the aggregate level of federal spending for the next year, break down that spending by major categories (but not by detailed line items), and indicate revenues to be available and the resulting deficit or surplus.

After this resolution was agreed upon, specific appropriations and tax bills would be passed in line with the aggregate numbers specified in the resolution. The figures in the first resolution, however, were regarded as targets and were not absolutely binding. In the final stage Congress would reconsider whether the targets were still appropriate and, if necessary, reconcile specific bills with the desired aggregates. A second concurrent resolution on the budget — this time a binding one — would then be passed.

The 1974 law gave Congress a much needed mechanism for making overall budget decisions. Unfortunately, it also made an already complex and lengthy decision process still more complicated and time-consuming. The new procedure retained all the existing authorizing, appropriating, and tax writing committees and added yet another layer:

"Unfortunately, [the 1974 law] also made an already complex and lengthy decision process still more complicated and time-consuming."



Robert Wisner

the budget committees. The resulting schedule of detailed and difficult decisions to be made in sequence each year was impossibly demanding, even if reasonable agreement existed on overall budget policy.

For example, it soon became apparent that two budget resolutions were too many. The compromises on budget priorities needed to pass a first budget resolution were difficult to achieve and often occurred later than the May 15 deadline. Once an agreement was reached, no one wanted to reopen the arguments. Hence the second resolution quickly became a formality, then was officially folded into the first.

The new decision process established by the Congressional Budget Act of 1974 accomplished its major purpose. It gave Congress a forum for deciding fiscal policy. The new procedures were expected to strengthen congressional power at the expense of the president's. However, in 1981 President Reagan, aided by his aggressive budget director David A. Stockman, used the centralized features of the congressional budget process effectively to obtain congressional approval of drastic changes in the federal budget. The major elements of the Reagan program—tax cuts, increases in defense spending, and reductions in domestic spending—were embodied in a three-year budget resolution and passed by Congress as a package.

Reconciliation, the process originally associated with the second budget resolution, was used to bring entitlement programs and other ongoing spending legislation into conformity with the reduced domestic spending totals in the first (and only) budget resolution. These numerous, complex, and sometimes far-reaching changes in existing laws were also voted as a single package.

The events of 1981 showed that a president with strong views on budget priorities and a recent election mandate could use the congressional budget process to obtain rapid ratification of dramatic changes in the budget as a whole. The fragmented decision process that existed before the 1974 reforms would have made these instant, simultaneous changes in many parts of the budget much less feasible. President Reagan's use of the reconciliation process for wholesale alteration of detailed spending legislation, however, left many congressional committees, especially in the Democratic House of Representatives, bruised and determined to reassert their traditional powers.

The budget decisions made in 1981 resulted in enormous deficits in subsequent years. The tax cuts reduced federal revenues as a percent of gross national product while spending continued to increase. The future deficits were not anticipated in 1981, in part because the budget resolution assumed unspecified future cuts in domestic spending that never materialized. More important, however, the budget resolution was based on optimistic economic assumptions that soon proved totally unrealistic. The recession precipitated by high interest rates in 1981 caused a rapid surge in deficits. Financing an escalating debt at high interest rates led to unprecedented increases in federal spending for interest payments. As a result, increases in spending for defense and interest substantially exceeded cuts in domestic spending, leaving a growing deficit even as the economy recovered.

Beginning in 1982, rapidly escalating deficits subjected the entire federal budget process to extreme stress. Under this stress two weaknesses of the decision process stood out

clearly: the basic problem, built into the Constitution, of resolving any difficult problem when the president and Congress disagree, and the layering of the process that made it unwieldy and time-consuming in normal times and close to nonfunctional under stress.

Difficulties of Divided Power

The debate over each successive budget since 1981 has been dominated by clashes of views over the deficit. Between 1982 and 1984 President Reagan vacillated on the seriousness of the deficit, sometimes alleging that it would disappear as the economy grew and sometimes deploring it and calling for reduced domestic spending. Presidential budget proposals reflected a consistent budget strategy that continued the defense buildup, rejected both tax increases and cuts in social security, and proposed substantial reductions in many domestic activities. Congressional leaders generally made stronger statements about the necessity of getting the annual deficits down, but differed with the president and with each other on how to do it. Actual budget actions reflected painfully engineered compromises that generally pared back the president's defense increases, accepted some but by no means all of the proposed domestic cuts, and raised revenues somewhat, most notably in 1982 when aspects of the generous tax cuts of the previous year were rescinded. The result was to reduce anticipated further increases in the deficits but to leave them still at unprecedented levels even though the economy began recovering rapidly in 1983.

By 1985 both the administration and Congress had come to realize that the deficits would not disappear with economic growth and were a threat to the long-run health of the economy. But views on what to do about them had not converged. The battle over the fiscal 1986 budget was long and bitter. It resulted in congressional rejection of further defense increases in that year and of most of the deep domestic spending cuts proposed by the president. The president first accepted and then pulled away from a Senate-passed proposal to suspend the social security cost-of-living adjustment and similarly rejected all efforts to reduce the deficit by increasing revenues. Although final budget actions made inroads on future deficits, the conflict left all parties feeling frustrated, discouraged, and helpless.

In this atmosphere the Gramm-Rudman-Hollings proposal was offered in the fall of 1985 as an amendment to a necessary increase in the debt ceiling. Unexpectedly, it gained wide support. Although members of his administration expressed reservations about the approach, especially about the possible impact on defense spending, the president endorsed the proposal and it passed quickly.

The law sets annual targets that reduce the budget deficit to zero in fiscal 1991. If in any year agreement cannot be reached on the specific measures needed to achieve those targets, the law provides a mechanical formula that cuts defense and civilian spending in approximately equal amounts sufficient to meet the goal.

The impact of the new law was felt immediately. Application of the law's mechanical formula on a limited basis in fiscal 1986 cut \$11.7 billion from spending in that year and reduced the spending base by substantially more than that for future years. Reaching the targets by applying the formula in 1987 and beyond, however, would seriously im-

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pair the effectiveness of both civilian and defense programs. It is hard to believe Congress and the president will allow this to occur. The hope is that the desire to avoid this outcome will bring about agreement on a more sensible way of reaching the targets.

The current situation is complicated, however, by the possibility that the Supreme Court may uphold a circuit court ruling that the automatic formula is unconstitutional because it involves having an officer of Congress (the comptroller general) certify what cuts are to be made by the president. The lower court held this to be a violation of the constitutional separation of powers. If the Supreme Court upholds the lower court, Congress can still use a procedure in the law that involves voting to withhold the funds specified by the formula. It might be reluctant to do this, however, and if it did, the president could veto.

Even if Gramm-Rudman-Hollings forces agreement on a deficit reduction plan, it is an undesirable budget process. First, the procedure, which requires cutting every unexpired line item in the budget by a fixed percentage, allows no reconsideration of priorities and could lead to absurd and unintended results. Second, the adoption of a fixed dollar target for the deficit can destabilize fiscal policy.

Finally, Gramm-Rudman-Hollings does nothing to reduce the layering and complexity of the current budget process. The law does strengthen enforcement of the budget resolution, which should improve congressional self-discipline, but it also adds to congressional workloads and accelerates deadlines that were already proving impossible to meet. For example, the law requires Congress to pass the budget resolution by April 15, although the current deadline of May 15 has not been met in some years. Deadlines are missed in large part because the process itself is overly complicated. Congress will not solve this problem merely by exhorting itself to try harder to finish on time.

Ways to Simplify the Process

Even before it was subjected to the stress of dealing with large deficits and divergent views among House, Senate, and president, the budget process was showing signs of breaking down of its own weight. Participants complained about the length of time spent on each budget — at least six months for preparation of the president's proposal and at least nine months for congressional decisions. Deadlines were missed regularly, and continuing resolutions became more and more frequent because agreement often could not be reached on regular appropriations. Participants also complained about the multiplicity of congressional committees with overlapping jurisdictions. Testifying on the same issues before several committees on both sides of the Hill consumed the time of executive branch officials and members of Congress alike.

Moreover, the frequency with which the same issues came up for consideration meant that many decisions were never final. Crucial votes on major weapons systems, such as the MX missile, were occurring in each house three or more times in a single year in the context of authorization, appropriation, and budget action. Congress seemed more and more immersed in the details of federal programs and less and less concerned with the overall directions of federal policy. A growing number of members and observers of Congress have come to believe that drastic change is

needed to improve the effectiveness of the congressional budget process. But the deficit crisis itself has delayed serious consideration of procedural change.

Three types of reform would make effective decision-making more feasible: making decisions less often by moving to a multiyear budget, reducing the number of committees by consolidating the authorizing and appropriating processes, and simplifying the budget itself by reducing the number of accounts and line items.

Multiyear Budgeting

An obvious way to reduce the time spent on the budget process would be to go through the process less often, perhaps every other year. Less frequent budgeting has many clear benefits. The managers of federal programs and the recipients of federal grants could plan programs more effectively if they could assume funding for a longer period. They could spend more time managing and less time preparing and defending budgets and adjusting to funding changes. And Congress, relieved of annual budget battles, could devote more attention to long-run issues and more careful oversight of federal programs.

Spending levels for some programs are, of course, affected by unpredictable cataclysmic events, such as the outbreak of war. But such events have to be dealt with on an emergency basis even with an annual budget process. It is hard to imagine that most federal programs benefit more from hasty annual review than from more thorough, better prepared evaluation at longer intervals.

It is true that budgeting depends on economic assumptions about the future and that longer-run forecasts are more uncertain. But only a few programs are greatly affected by the state of the economy, and many of these are entitlement programs that adjust automatically. If the econ-

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omy suffered an unexpected recession in the middle of the multiyear budget period, Congress might well want to consider changing tax rates or accelerating some spending programs. But this could be done — as it is now — without reconsidering the whole budget.

Numerous bills proposing multiyear budgets have been introduced — most calling for biennial budgeting, which is used by many state governments — and some hearings have been held. Some biennial budget bills envision Congress spending the first year of each session on program oversight and other matters and handling the two-year budget in the second year of the session. Under this arrangement a newly elected president who wanted to alter his predecessor's budget either could use the first year of his term to build support and understanding for the changes or could move ahead more rapidly to amend the existing budget. Other bills would have each Congress make a two-year budget in its first session and use the second to consider other legislation.

Even if the whole budget were not moved to a multiyear basis, Congress could get many of the same advantages by shifting to multiyear authorization or appropriation or both in major areas of the budget. Defense seems an especially good area for such a change. Indeed, recently enacted legislation requires the Department of Defense to submit a two-year budget beginning with fiscal 1988 and 1989.

While legislators sometimes argue that they would have less control over federal activities if budgeting were done less often, they actually would be better able to make significant changes. Major shifts in direction, such as bringing down the deficit or modernizing the armed forces, cannot be accomplished in a single year. A longer budgeting period would give greater scope for such major shifts to be designed and carried out. Indeed, in the last several years Congress has of necessity moved to a multiyear budget resolution with accompanying reconciliation measures. The dramatic changes of 1981 involved a three-year budget resolution as well as a three-year tax bill. Subsequent efforts to bring down the deficit necessarily involved more than one year, so three-year budget resolutions have become standard. Nevertheless, appropriations and many authorizations are still done one year at a time. It is time to move the whole process to a two-year cycle.

Consolidating the Authorizing and Appropriating Functions

In principle the legislative or authorizing committees write the basic legislation that governs how federal programs function, and the appropriations committees budget specific sums to carry them out. In practice the distinction between the two has often blurred in recent years, perhaps because of the intensity of interest in the budget and the small number of new programs being considered. In working out the defense budget, for example, the authorizing committees and appropriations subcommittees often appear to be doing exactly the same thing — subjecting the budget to line-by-line scrutiny with special attention to procuring weapons systems. Such duplication wastes the time and energy of Congress and executive branch alike.

On the other hand, spending for entitlements, now two-fifths of the budget, is outside the appropriations process. The bulk of entitlement spending is handled by the tax

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committees, sometimes creating logjams for these over-worked committees.

Restructuring the committees would improve the budget process. Ideally each major area of federal activity — defense, income security, national resources, and so forth — should have a program committee responsible both for drafting basic legislation and for reviewing budgets in its area. Each would handle both entitlement programs and discretionary appropriations. Revenue committees would handle only revenue, not spending, programs. The budget committees would be charged with putting together an overall budget strategy that would include both revenue and spending. They would also consider relative priorities among programs and recommend appropriate fiscal policy.

A further step, one with considerable appeal, would be to hold all spending and tax bills for final vote at the same time. Indeed, they could be put into a single bill. Congress would then be voting on a budget for the whole government and sending it to the president in one package. This type of budget action is standard in many governments, but the U.S. government has never had a budget voted this way.

Reducing Micromanagement

Under present procedures a single omnibus appropriations bill would be an appallingly long document. This length is symptomatic of a basic problem of the budget process: the tendency of Congress to budget in too much detail. The current budget is divided into thousands of budget accounts and subaccounts. The executive branch is given very detailed line item budgets with little authority to shift money from one item to another as conditions change. This detail makes the budget process an arcane business and

focuses congressional time and energy on minutiae rather than on overriding issues of policy.

Drastically cutting the number of line items in the budget would be desirable but would make a real difference only if accompanied by a genuine change in the way Congress perceives its own role. Congress would have to begin functioning more like a board of directors making major policy decisions for the country and less like a group of 535 managers specifying detailed operations for the executive branch.

None of the changes suggested here would require amending the Constitution. Each could be accomplished by legislation or changes in House and Senate rules and customary practice. All the recommendations, however, would meet with strong opposition in Congress (and to some extent in the executive branch) because each threatens the existing power structure. Multiyear budgeting would deprive Congress of the annual chance to impose its will in appropriations and other budget legislation. Consolidating the authorizing and appropriating processes would reduce the number of committee and subcommittee chairmanships.

Budgeting in less detail is perhaps the most threatening of all, because Congress has a long tradition of making itself felt and protecting constituent interests through tinkering with line items. Nevertheless, Congress is highly frustrated with the current system, which imposes an exhausting workload but yields little satisfaction of accomplishment. Once the deficit crisis is at least partially resolved, but before memories of this stressful period recede, the chance for substantial reform of the budget process seems high.

Other Possible Reforms

President Reagan favors two major changes in budget procedures that he believes would work to hold down federal spending and deficits: a constitutional amendment to require a balanced budget and a line item presidential veto. Both proposals are troublesome.

Requiring balance in the budget regardless of the state of the economy could force the federal government to adopt an inappropriate fiscal policy. Drafts of constitutional amendments usually have escape clauses, but it is difficult to foresee the variety of special circumstances that could affect future fiscal policy. Such amendments usually empower a super majority (two-thirds or three-fifths of Congress) to override a requirement to balance the budget. Such a clause, however, might create an incentive for legislators with favorite spending projects to trade the inclusion of these projects for their agreement to join the super majority. Spending and deficits might actually end up larger than without the amendment. To the extent that an amendment to balance the budget holds down federal spending, however, it may lead the government to substitute additional regulation for spending and to achieve goals by requiring businesses or state and local governments to make certain kinds of expenditures. Such amendments also provide a strong incentive to create off-budget agencies or engage in "creative" accounting. All in all, the risk of trying to handle a complex issue like fiscal policy by amendment to the Constitution, whose greatest virtue is its brevity and flexibility, seems far greater than the benefits.

The proposed line item veto also presents problems. While the president may use his veto power only to reject a

whole bill, many state governors have the power to veto individual line items without rejecting the whole bill. Numerous presidents have asked for a line item veto, a power that they hoped would forestall the congressional tendency to insert spending items with which the president disagrees into bills he needs and does not want to veto.

The line item veto would enhance the power of the president and diminish that of Congress, but it is easy to exaggerate its impact. The president needs congressional support for his programs and is unlikely to risk antagonizing many members, especially chairmen of important committees and subcommittees. Moreover, the latter could doubtless find ingenious alternative ways of protecting favorite line items, such as military bases or other federal installations, from presidential veto. A committee could hide a threatened line item in a larger total, for example, but add language stating that none of the funds are to be used to close the specified installation. Moreover, while a conservative president might use a line item veto to cut pork barrel spending projects, a big-spending president might use the threat of a line item veto to garner votes for spending he favored.

In any case it is not realistic to think that the line item veto would reduce the current deficits appreciably. President Reagan is unlikely to use a line item veto to reduce defense spending. Interest payments cannot be vetoed, and entitlement programs generally do not come to the president in a form in which such a veto would be possible. The president might use the line item veto to kill a few domestic spending items of largely local interest, but the spending impact of such actions would be small.

Conclusion

Simplifying the budget process along the lines discussed would make the process more understandable and less exhausting and would probably lead to more thoughtful decisions. It is important, however, not to claim too much for procedural change. A well-designed budget process can, at best, do three things. It can reduce but not eliminate uncertainty by making sure that participants have the best available projections and analyses of budget options in intelligible form. It can also put the sequence of decisions in a logical order so that participants have a chance to make the most important decisions, not just the subsidiary ones. This lack of order was the weakness in the congressional budget process corrected by the reforms of 1974. Finally, a well-designed budget process can save time for decision-makers so that budget affairs do not overwhelm other activities of government. The current process fails miserably on this last criterion.

No set of procedures, however, can force participants to make choices that they do not want to make or do not regard as necessary. Reforms to the process cannot substitute for political will or for the exercise of leadership in working out compromises among warring parties. As long as the government sticks with a system under which power is divided between the president and Congress — and separation of powers should be maintained — the priorities of the president and Congress will occasionally conflict. Changes in the budget process are unlikely to cure this situation. Resolution of the conflict will still require statesmanship and the willingness of both sides to compromise.

Buying Weapons: Bleak Prospects for Real Reform

Thomas L. McNaugher

ONCE AGAIN the federal government is trying to reform the way it buys weapons. It has tried several times before. The 1947 legislation that brought the services together under a single Department of Defense sought in part to rationalize procurement. In 1958 the chaos that marked weapons acquisition in the Eisenhower Defense Department drove members of Congress to legislate a substantial increase in the power of the secretary of defense. Expensive and troubled weapons projects of the McNamara era, notably the C-5A and F-111 controversies, led in 1969 to the appointment of a "Presidential Blue Ribbon Commission on Acquisition Reform." The "Fitzhugh Report," named after the commission's chairman, Gilbert Fitzhugh of Metropolitan Life, then became the basis for a set of reforms promulgated in May 1970 by David Packard, then deputy secretary of defense. Now, some fifteen years later, tales of waste, fraud, and abuse in the nation's procurement apparatus have brought Packard back to town, this time at the head of his own blue-ribbon commission. The commission's report on the weapons acquisition process appeared late in April.¹

Reformers have been saying the same thing for nearly forty years. They would like to consolidate power over weapons choices, bring order to force planning, and impart greater efficiency and common sense to the development and production of new weapons. They usually agree on means as well — on the need for better cost estimating, more comprehensive testing of weapons, and, overall, stronger central authority in the Defense Department. Often their ideas have been incorporated in legislation. Yet upon taking charge of his blue-ribbon commission David Packard admitted that things are worse today than when he was deputy secretary of defense fifteen years ago.

Is the Packard Commission report likely to change the pattern? Probably not, despite the fact that many of the commission's recommendations will soon find their way into law. Over the course of the postwar era an approach to developing and acquiring weapons that is highly resistant to order has been set in place. Indeed, weapons acquisition is structured in a way that virtually precludes order. Procedural reforms like those offered by the Packard Commission and others before it do not touch this basic structure. For precisely that reason, however, their effects are likely to be marginal at best.

AMRAAM and the Basic Pattern

The basic pattern of development is usefully illustrated by examining a specific project from start to finish, in this case the U.S. Air Force's Advanced Medium Range Air-to-Air Missile. The AMRAAM project is ambitious. It seeks to develop a missile that can see and "lock on" to enemy aircraft from distances of 50 miles or more. Once fired, the missile is designed to follow its target by itself, leaving the

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pilot who launched it free to focus on other missions. In Pentagon jargon, AMRAAM is meant to be a true "fire-and-forget" weapon.

At this writing, AMRAAM is plagued by controversy. Behind schedule but approaching production, the project has experienced a degree of cost growth in recent years untypically large even by defense standards. Some critics question whether the missile is still worth its cost, others wonder whether it will work, and still others question the whole concept of a radar-guided, "fire-and-forget" missile. It is a strange debate to be having now, after over a billion dollars have been sunk into developing the missile and partially equipping two plants for its production. Yet AMRAAM's development proceeded in a way that made it difficult to raise many of these questions at a more appropriate moment.

The project began in a wave of optimism. Testifying before members of Congress in 1977, the first AMRAAM program manager announced that the Air Force was seeking a missile smaller yet more effective than its existing radar-guided missile, the AIM-7 Sparrow, for half the cost, or roughly \$40,000 to \$50,000 (1978 dollars).² It would be hard for anyone to oppose the development of a missile four times as cost-effective as one already in production. Few did. The project was approved.

Three years later the missile's cost was estimated to be roughly \$115,000 in 1978 dollars, nearly three times the earlier estimate, but still less than the Sparrow, whose cost also had risen in the meantime. Progress looked good — so good that the Air Force had actually shortened the "concept validation" phase of the program, even while "the scope of work was expanded significantly."³ The missile still appeared to be cost-effective and was approved for full-scale development. The contract was awarded to Hughes Missile Division in December 1981.

It was a contract in which Hughes and the Air Force traded risks.⁴ Seeking to force Hughes to absorb the risks of the missile's further development, the service insisted on a fixed-price contract despite the obvious technical sophistication and complexity in the missile's design. Hughes agreed, but only on condition that the decision to produce the system be made by a specific date rather than on the basis of progress in development. Thus the Air Force agreed to accept financial penalties, and to renegotiate production costs, should production of AMRAAM not be approved by November 1984. Significantly, no one expected to see

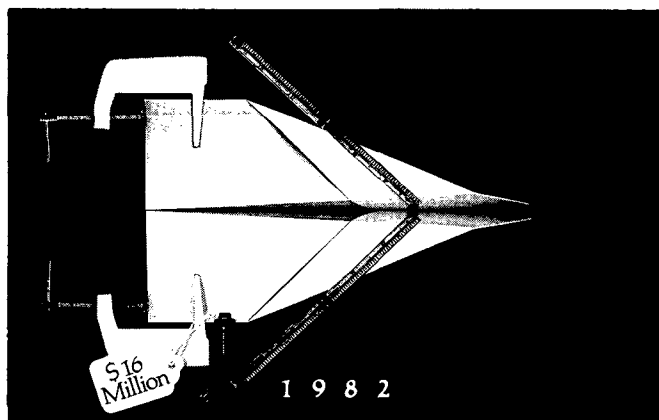
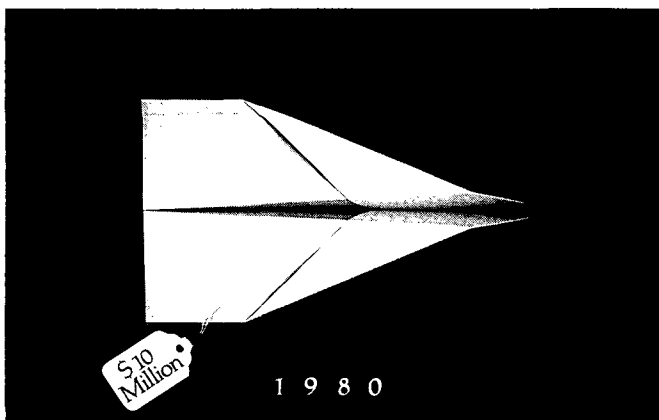
AMRAAM actually launched from an aircraft before August of that year, only three months before the decision on production would be made.

Development proceeded, as did the financing of production lines at Hughes and later at Raytheon, selected as the missile's competitive second source. By March 1984, however, Air Force officials told members of Congress that the project had begun to experience "growing pains" because "task complexity [was] . . . greater than initially expected." The AMRAAM development schedule was stretched three months. Still, the service saw "no serious technical problems," and most of those involved in the project thought a production decision would be made by the November deadline.⁵ By late 1984, however, continuing technical difficulties had forced the service to forgo flight testing as well as the production option. The missile's development was stretched still further. Members of Congress were steadily drawn into a sharpening debate on the missile's future.

In January 1985 Defense Secretary Caspar W. Weinberger called the AMRAAM program to a temporary halt while the Air Force sought to simplify the missile's design without sacrificing the performance levels required by Congress. Congress also wanted guarantees on the missile's future cost. In February 1986 the defense secretary finally approved continuation of the project and promised Congress that the missile would meet cost and performance guidelines.

In the meantime, information useful for judging the missile's worthiness began to surface. As so often happens when weapons become controversial, estimates of how much the missile will really cost have proliferated.⁶ Weinberger has certified to Congress that AMRAAM will cost roughly \$200,000 a copy in 1978 dollars (or \$305,000 in current dollars). Raytheon says it cannot produce the missile for less than \$260,000 a copy in 1978 dollars. And Anthony Battista, senior staff member of the House Armed Services Committee and one of the project's more vocal critics, argues that the missile will probably cost \$500,000 a copy, again in 1978 dollars. The Navy's Phoenix, a less sophisticated radar-guided air-to-air missile in production since the mid-1970s, provides a point of comparison: it cost over \$400,000 a copy in 1978.⁷ Obviously great uncertainty about price remains. But it is clear that the missile will be substantially more expensive than originally predicted.

We have also seen the missile fly. The first actual flight test of an AMRAAM was conducted successfully on



December 7, 1984, and has been followed by several more. Test results remain ambiguous, however. Ten of twenty test missiles delivered to the Air Force have been returned to Hughes "to correct some malfunction." Four of the first five flight tests were successful; the fifth missile failed to launch.⁸ Although performance, like cost, remains uncertain, emerging information should permit a more realistic appraisal of AMRAAM's cost-effectiveness.

But such an appraisal comes too late. The appropriate time for it would have been early in the program when investments remained small. At that point, however, program decisions were made on the basis of unrealistically low cost estimates. In 1985 decision-makers were confronted with firmer cost and performance figures, but also with sunk costs of more than a billion dollars, two partially equipped production plants, and the political constituencies those expenditures had created. The Air Force contends that AMRAAM remains cost-effective, though one has to question the validity of calculations that are insensitive to a manyfold increase in the missile's projected cost. More to the point, however, one has to question whether the issue of cost-effectiveness had much bearing on Weinberger's decision to continue the project.

To be sure, AMRAAM is an extreme case because of its exceptional ambitiousness and its relatively large cost growth. But the AMRAAM project's structure is typical, and the questions it raises about cost-effectiveness can be raised about a host of other weapons. Most weapons projects begin on an optimistic note. Companies eager to win future production contracts face powerful incentives to bid low on development.⁹ So do services eager to fund an array of important projects within limited budgets. Service program managers may suffer from excessive enthusiasm; it is hard to find another explanation for initial cost estimates less than one-tenth the actual cost of the Navy's Phoenix. But program managers may also willingly accept the contractor's optimism — even lock it into a contract — to better their bargaining leverage as development proceeds.

Projects that begin optimistically inevitably toss up tough choices when original cost, schedule, and performance estimates start to unravel. Evidence from the past two decades points to a strong and consistent tendency for the services to insist that a weapon meet original performance specifications even if they must pay more and wait longer for it.¹⁰ Often the services actually *raise* original performance goals midstream, contributing more technical uncer-

tainty to the project and increasing the probability of still greater cost growth.¹¹ Of the original requirements, performance goals tend to exhibit a ratchet-like upward flexibility; cost and schedule appear to be more easily sacrificed.

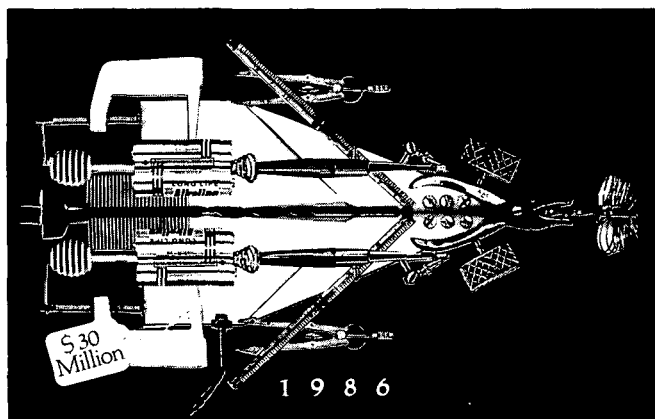
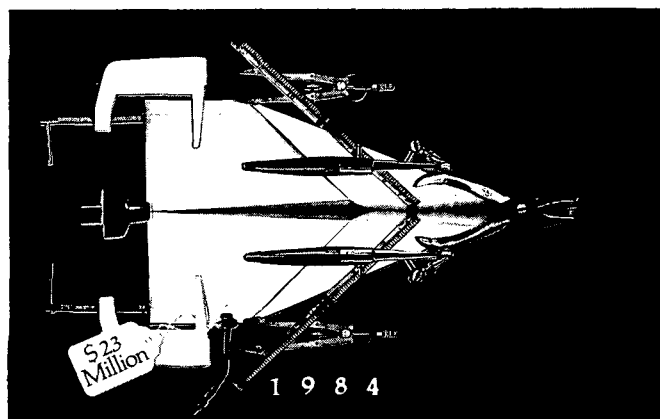
Despite the addition, in many cases, of more uncertainty even as development proceeds, most projects end in a rush. Planning and "tooling up" for production usually begin well before development ends; recall, for example, that AMRAAM production options were negotiated at the start of full-scale development. Rarely is developmental testing complete before a decision on production is made. Testing for reliability and operational suitability follows much later.¹² Having sacrificed original schedules to obtain performance, the services move quickly to field systems before they become obsolete. Consequently they often begin production before they know what they are buying.

The Problem of Design

By outward measures the current way of doing business succeeds most of the time. The nation's force posture remains impressively sophisticated. The weapons in it do not necessarily work reliably, however, especially when they first go to the field. Nor can they be expected to under current practice: the dominance of developmental testing over operational testing sends a clear message to contractors and Pentagon program managers alike that delivering performance is more important than delivering reliability or operational suitability.

Months, even years, after they have been deployed, weapons systems are often refitted to improve their field performance. But by then the revamping is constrained by the complexities and economies of altering hardware already in use. One can only wonder what levels of reliability might be achieved were developers encouraged to emphasize it from the start.¹³ One also wonders why the services rush through testing only to field systems that take some time thereafter to work properly.

The real question, however, concerns whether all of this sophistication is worth the money the services pay for it. Elaborate capabilities may look cost-effective when the program begins, but then the numbers are optimistic and the overall design exists only on paper, where designing is easy. As the expense of obtaining original performance



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goals rises, the cost-effectiveness of that performance declines. But accurate measures of cost and effectiveness usually emerge only after projects have acquired a degree of political momentum that makes them difficult to stop. Cancellation, even of an obviously flawed system like DIVAD, the Army's ill-fated air defense gun, provokes pitched political battles. Far more often systems make it unchallenged into the inventory. By this pattern we assure ourselves of a gold-plated arsenal — one that includes capabilities simply not worth their price.

The Problem of Planning

The way development is organized affects more than the design of individual weapons: it hampers the Defense Department's ability to plan the overall force posture. After all, how can anyone plan on the basis of erroneous numbers? In fact, no one does. The "Five Year Defense Plan" remains a central Pentagon budget document, but cost growth and schedule slippage in individual weapons projects undermine the validity of all but the first year's numbers. As

costs, schedules, and performance are clarified late in development, the services are forced to alter their original plans. They may buy weapons in smaller quantities than planned, or buy hardware at the expense of training and spare parts, or buy a mix of forces quite different from the one they had in mind some years earlier. In short, individual weapons projects tend to overwhelm planning for the whole force. Unfortunately, forces, not weapons, win wars.

Like studies before it, the Packard Commission report seeks to create a stable planning environment. It speaks of realistic five-year budget projections, and it calls on Congress to approve funding for individual projects not annually, but only upon their entry into full-scale development and high-rate production. Congress, of course, has not yet even been able to come to terms with biennial budgeting, proposals for which remain stalled after over a year's debate. Congress is unlikely to relinquish annual control over major portions of the federal budget, since by so doing it deprives itself of the flexibility needed to deal with a host of fiscal and political uncertainties, from budget deficits to disputes over foreign policy.¹⁴

In any case, too much of the blame for so-called "budget instability" can be foisted on Congress. To the extent that the services routinely crowd a host of optimistically priced projects into their annual budgets, they guarantee future budget instability in all save those rare cases when defense budgets rise dramatically and unexpectedly. We have just seen such a period. We are now watching its demise, and few expect to see another for many years to come.

Incentives for more accurate cost estimates should be created; the Packard Commission recognizes this in calling for "budgeting for most likely cost."¹⁵ Cost-estimating tools have grown more powerful over the years, but they are only as good as the data bases on which they draw. The enormous cost growth in the AMRAAM case may result partly from the lack of an extensive data base for sophisticated radar missiles. So long as the nation successfully pursues its strategy of technological superiority, its cost-estimating tools are likely always to run behind the systems whose costs must be estimated — even in the absence of the pervasive incentives for optimistic projections built into the budgeting and contracting process. As the Fitzhugh Commission noted in 1970, "one cannot place a price on the unknown."¹⁶

The Problem of Control

Perhaps the most serious question raised by current procurement practices concerns control over the acquisition process. If, as a general rule, the true cost and capabilities of an evolving weapon emerge only as it becomes increasingly difficult to modify or cancel, who actually controls the project? Is anyone in a position to state real cost and performance — based on testing of real hardware — and make a decision on the weapon's fate unbiased by political pressure to move ahead? The Packard Commission would have an under secretary of defense for acquisition focus all his energy on weapons projects. Yet this individual is likely to fare no better than past deputy secretaries of defense, who traditionally have overseen procurement. He will set in motion projects that will reach production long after he has gone, and he will encounter projects entering production whose momentum he will find difficult to stop. He will

quickly learn that his power is more political than legal in nature and as such must be used sparingly.

The problem is only compounded by rapid turnover of military as well as civilian managers: no one is around long enough to enforce consistent goals on a project. It is only a slight exaggeration to say that no individual in the Defense Department — military or civilian — fully controls specific weapons projects. In a system in which political appointees come and go, control over acquisition devolves to the services. But service chiefs and program managers rotate almost as frequently as civilian appointees. Thus, projects tend to be controlled indirectly by service priorities, which are far more consistent among service members than among civilians who may belong to administrations with quite different strategic goals.

In this important sense, *how* the government buys weapons is closely linked to *what* weapons the government buys or fails to buy. Why is it, for example, that the Air Force and Navy generally sacrifice the purchase of more air- and sea-lift for the purchase of mainstream systems like fighter aircraft and aircraft carriers? It is surely not because the lack of adequate transport has gone unnoticed; in fact, several defense secretaries have sought to increase the nation's lift capabilities. But these individuals come and go, and the confusion that follows from shifting styles and goals at the top allows service priorities to reassert themselves. Strategic lift slowly falls down the priority list while more important service priorities — a strategic bomber, for example, perhaps even one canceled four years before — work their way back to the top.

Politics and the Acquisition Process

Ideally, the weapons acquisition process should allow objective decisions to be made on the basis of accurate information concerning cost and the full range of a weapon's performance — reliability as well as flight envelope, operational suitability as well as technical elegance. Clearly more weapons testing is in order. The Packard Commission's call for more of it before full-scale development begins is a step in the right direction *if* the services do not alter performance requirements during full-scale development, as they do now. Freezing requirements early would also speed the development process, now considered by most observers to take too long, by reducing the number of *new* uncertainties injected into a project midstream. Testing

would delay fielding of the full force by some period, but the weapons would work better in the field — a reasonable trade.

Gathering hard information from tests is not likely to be very helpful, however, if there is nothing to choose *from* — if the only alternative to buying a weapon is to go back to the drawing board, leaving the force posture to become still more obsolete. Theories of research and development have always called for the development of alternatives, and competing prototypes of a new weapon are routinely brought through early development. But these rarely differ in significant ways, and the effort is normally aimed less at providing conceptual or technical choices than at augmenting service leverage over contractors. Far preferable would be a system in which genuine alternatives were developed to a point where testing could evaluate their relative *operational* as well as technical merits and in turn allow for informed choices.

Such an approach would represent a significant structural departure from current practice. It would involve a much clearer separation of research and development from production than is currently the case, and it would require greater and more consistent funding of alternative full-scale development projects. The Packard Commission argues that the Defense Advanced Research Projects Agency (DARPA) should be authorized to bring more alternatives into the prototype stage of development. This is one way to generate alternatives. But DARPA's budget for fiscal 1986 is \$670 million — less than the development cost of AMRAAM. It would have to be many times that to bring really useful alternatives into existence.

But the more imposing barrier to structural reform springs from the very nature of American politics. Research and development require a willingness to invest money "up front" in return for long-term gains. But long-term gains are rarely meaningful to members of Congress who face frequent reelection contests. To be sure, Congress has often been quite generous with research and development funding. But such funding tends to come in waves generated by fear — the Cold War — or by popular vision — manned space flight or the Strategic Defense Initiative. These efforts may add substantially to the nation's technology base, but they do not produce weapons alternatives that would open the acquisition process to more objective decision-making.

Instead, funding alternative designs all too often looks

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wasteful — and is, from a short-term perspective. Ironically, congressional reluctance to fund real alternatives only drags members of Congress more deeply into a realm where few wish to intrude. For Congress, the primary procurement issue — the issue that involves both constituency interests and large budget allocations — is production. Line item review of research and development is often confusing and tedious. Yet if production choices are set early in development, members of Congress have little choice but to involve themselves in such reviews.

For service program managers, this means time-consuming trips to Capitol Hill each year to defend their projects. More important, however, legislative politics imposes a set of values on the actual flow of development that is quite out of keeping with the requirements of research and development. The best weapons projects unify authority and power in a single individual or a small design group; American politics fractures power across two branches of government and countless agencies within each one. The best weapons projects are marked by sharp trade-offs that can only be made under conditions that encourage flexibility; American politics favors consensus, and, once struck, political bargains can be anything but flexible. Understanding acquisition as a political rather than a managerial undertaking helps explain why weapons requirements are overly complex at the start and inflexible as development proceeds.

Not surprisingly, acquisition reform usually seeks to get politics out of development. The Packard Commission, for example, calls for short and clear lines of authority, a reduction in paperwork, and less frequent congressional review. Yet the call runs against postwar trends moving in precisely the opposite direction. Only by restructuring the acquisition process in a way that brings meaningful alternatives to fairly advanced stages of development would it be possible to take politics out of development and focus it instead on the production choice.

Such a change would be a radical reform within the context of the political system in which the acquisition process is embedded. Short of these changes, however, the basic program structure embodied in AMRAAM and so many other weapons projects will continue to pose the vexing planning and control problems that have marked acquisition thus far. Radical change may come hard, but it may also be the only way to effect real improvement in the way we buy weapons.

1. President's Blue Ribbon Commission on Defense Management, "A Formula for Action: A Report to the President on Defense Acquisition" (Defense Department, April 1986). This was preceded by "An Interim Report to the President" (Defense Department, February 28, 1986), which dealt with broader issues of strategy and planning as well as acquisition.

2. Senate Armed Services Committee, *Department of Defense Authorizations Hearings*, FY 1978, 95 Cong. 1 sess. (Government Printing Office, 1977), Part 7, p. 4624.

3. The schedule was shortened partly to save money. See Senate Armed Services Committee, *Department of Defense Authorizations Hearings*, FY 1980, 96 Cong. 1 sess. (Government Printing Office, 1979), Part 3, p. 1159.

4. On the AMRAAM contract, see in particular Robert W. Ropelewski, "USAF Weighs 20 Modifications to Cut AMRAAM Cost \$1 Billion," *Aviation Week and Space Technology*, July 8, 1985, pp. 21–23.

5. Senate Armed Services Committee, *Department of Defense Authorization Hearings*, FY 1985, 98 Cong. 2 sess. (Government Printing Office, 1984), Part 3, pp. 1712, 1749.

6. Cost figures here are taken from Rowan Scarborough, "AMRAAM Cost Estimate Tops Weinberger Pledge," *Defense Week*, March 24, 1986, pp. 1, 10. I have used standard Department of Defense deflators to convert current-year dollars to 1978 dollars in an effort to maintain a valid comparison with earlier cost estimates.

7. Department of Defense, *Program Acquisition Costs By Weapon System*, FY 1978, p. 43.

8. Tony Capaccio, "AMRAAM Slammed," *Defense Week*, February 24, 1986, pp. 1, 11. See also Melissa Healy, "A Troubled Missile Gets A Facelift," *Defense Week*, September 16, 1985, pp. 8–9.

9. In the AMRAAM case, for example, the House Armed Services Committee charged in 1984 that the "prime contractor had underestimated the costs of designing and fabricating the missile and its test systems by 50 percent and 100 percent respectively." Quoted in James B. Schultz, "What Fate AMRAAM?" *Defense Electronics*, April 1985, p. 72.

10. See in particular Robert Perry et al., *System Acquisition Experience*, RM-6072-PR (Rand Corporation, November 1969), and Edmund Dews et al., *Acquisition Policy Effectiveness: Department of Defense Experience in the 1970s*, R-2516-DR&E (Rand Corporation, October 1979), especially ch. 3.

11. In the Rand Corporation's study of 1970s acquisition projects, "unexpected technical difficulties" were a significant source of cost growth in 60 percent of programs far enough along to provide useful data. Yet the study found technical difficulties a "minor" source of cost growth in comparison to changes in requirements. See Dews, *Acquisition Policy Effectiveness*, p. 93.

12. Rand analysts found that the amount of developmental testing conducted in the average weapons project increased over the decade, suggesting improvements in this area. But they also concluded that "it is not clear that there is a corresponding increase in the demonstration of *operational suitability* before, or even soon after, production go-ahead" (emphasis in original). Dews, *Acquisition Policy Effectiveness*, p. 21, n. 20.

13. As the Defense Science Board noted in 1982, "decisions made early in the program acquisition cycle have major impact on the eventual life cycle costs of a system." Department of Defense, Office of the Under Secretary of Defense for Research and Engineering, Report of the Defense Science Board 1981 Summer Study Panel on "Operational Readiness with High Performance Systems" (April 1982), pp. 3–6. Two systems whose development involved steady emphasis on reliability combined with extensive operational testing of pre-production prototypes were the Army's Blackhawk helicopter project and its associated T-700 engine. The results have been quite impressive. See Deborah G. Meyer, "Simplified Fleet, More Missions Will Shape Army Aviation's Future," *Armed Forces Journal International*, October 1984, pp. 59, 78.

14. At this writing, Congress has asked the Defense Department to submit a biennial budget for fiscal years 1988 and 1989. Yet it remains doubtful that Congress will actually treat that submission on a biennial basis. The Armed Services committees, which handle authorizations, labored for nearly three decades to acquire annual control over procurement funding, in part to ensure co-equal power and status with the Appropriations committees. They have been understandably reluctant to back away voluntarily from a position they labored hard to acquire. See in particular Louis Fisher, "Annual Authorizations: Durable Roadblocks to Biennial Budgeting," *Public Budgeting and Finance*, Spring 1983, pp. 23–39.

15. "Interim Report," p. 14.

16. See Fitzhugh's testimony before the Senate Armed Services Committee, "Weapon Systems Acquisition Process," Hearings, 92 Cong. 1 sess. (Government Printing Office, 1971), p. 14.

When Is a Burden Not a Burden? The Elderly in America

Henry J. Aaron

THE PROBLEMS of supporting an aging population are arousing increasing concern in many developed nations. A cursory glance at demographic statistics and projections reveals the reason. The proportion of the population over age 65 is expected at least to double in many developed nations over the period from 1950 to 2020 (see table 1). The timing and size of this increase vary in important ways from nation to nation, but the pattern is universal. The ultimate ratio of the aged to total population, which depends only on birth and mortality rates, will be reached only in the mid twenty-first century and differs little from country to country.

In this paper, I shall suggest that the burdens imposed by an increasing aged population, defined as persons 65 or older, are exaggerated, but that the problems created by the growth in the number of the very old, arbitrarily defined as persons 80 or older, should cause greater concern than they do.

Demographics and the Labor Market

A sharp decline in mortality and birth rates is transforming the demographic profiles of all developed and many developing countries. Declining mortality rates are increasing longevity and producing concomitant growth in the proportion of the population that is aged while falling birth rates are reducing the proportion of the population that is young. Thus, while the burden of the young on active workers is easing, the burden of the elderly on those workers would seem to be increasing. These trends partially offset one another.

At the same time, the proportion of the prime age population in the U.S. labor force is also being subjected to two partially offsetting trends. On the one hand, labor force participation rates of women are rising. On the other hand, the proportion of prime age men who work has fallen because of early retirement, disability, and other factors. Because a much larger proportion of the population will be elderly in the future, the proportion of both men and women in the labor force is expected to decline after 2000.¹

Clearly projections of labor force participation in the distant future are subject to enormous uncertainty. But it is equally clear that one should take all of these trends into account in determining whether the burden of caring for the dependent population is rising or falling.

Figure 1 presents the necessary information to do just that. The bottom line shows the ratio of the aged population (65 and over) to the prime age population (20 to 64) for the United States. The middle line shows the ratio of the young population (aged less than 20) to the prime age population, and the top line shows the ratio of both the aged and the young to the prime age population. The total dependency ratio — the ratio of the sum of persons under 20 and over 64 to the

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Table 1.
Percentage of the Population
Aged 65 and Older
in Selected Countries,
1950–2020

Year	Canada	Germany	Japan	Nether- lands	Sweden	United Kingdom	United States
1950	7.7%	9.4%	4.9%	7.7%	10.3%	10.7%	8.1%
1980	8.9	15.0	9.0	11.5	16.2	14.8	11.3
2000*	11.8	16.5	14.9	14.1	17.2	14.9	11.7
2020*	16.1	21.2	21.0	20.8	21.9	17.4	15.4

*Projections

Source: *World Population Prospects: Estimates and Projections as Assessed in 1982* (United Nations Publications, 1985).

population between those two ages — declines from 1965 until 2010 when it begins again to climb; however, through 2060 it never again reaches the 1965 peak.

These ratios are oversimplifications in important respects. They assume that all persons 65 or over are dependent. In fact, 11.2 percent of the aged population is in the labor force.² They assume that the cost, direct and indirect, of dependent elderly persons is the same as the cost of dependent children, when in actuality it is almost certainly higher. They assume that the costs of dependent persons aged 20 to 65 should not enter into the calculations of the burdens imposed by the dependent population. This assumption may be defensible for dependent spouses, but it is not reasonable for the disabled, the imprisoned, or other unattached adults who are out of the labor force.

Despite all of these qualifications, one point is clear: statistics showing that the working age population is going to suffer a heavy burden because the number of elderly is going up are so misleading as to verge on deception. To be sure, the number of elderly will rise and so will the ratio of the elderly to the nonelderly adult population. But the proportion of children is going down, and the proportion of the nonelderly population that is working will remain above current levels. No balanced appraisal of the burden posed by the elderly can ignore these facts.

This conclusion is in no way undermined by projections that the proportion of the U.S. federal budget devoted to the elderly is rising, that it will continue to rise for many years, and that most federal spending eventually will be devoted to the elderly. These projected trends merely reflect two incontrovertible facts: that the proportion of the population that is elderly will rise, especially if birth rates remain low; and that the United States assigns a larger proportion of the cost of the elderly than of children to public budgets, and especially to the federal budget. Public budgets cover the costs of elementary and secondary education and a fair part of the costs of higher education; but these costs are borne by state and local governments and hence do not appear as federal outlays. While it is true that the United States lacks any type of allowance to families with children, a common feature of the social welfare systems of many developed nations, the costs of food, lodging, clothing, and other personal expenses for children are met predominantly through private budgets in all nations.

The data in figure 1 conceal any impression about the composition of the elderly. The ratio of the very elderly,

persons aged 80 or more, is rising sharply and almost continuously and will continue doing so into the indefinite future. The proportion of the population aged 80 or more is projected to rise from 1.8 percent of the total population in 1970 to 3.7 percent in 2000 and to 6.7 percent in 2035, when part of the baby-boom generation will have reached its 80s.

Few of the very elderly work. They are likely to be widows or, much less often, widowers. They are far more likely than persons aged 65 to 80 to be physically frail, to require the assistance of others in carrying out normal daily activities, or to need institutional care in a nursing home or a hospital. In short, few of the very old can contribute currently to the rather large costs they generate. The burden arises not so much from the fact that the very elderly are no longer working as from the heavy economic and psychological demands that they make on their families, social services, and medical care. If there is a "growing-burden-of-the-aged" problem, here is where it lies.

Two Methods of Measurement

The demographic statistics imply that because those over 64 are becoming more numerous, they will impose greater burdens on prime age adults. This presumption deserves scrutiny.

Economists have two ways of looking at the economic impact imposed on society by increases in the proportion of the aged population. According to the nation-as-a-whole view, the burden arises because the aged use resources but, to the extent they are retired, do not currently produce them. Therefore to support retired persons and other dependents, active members of the labor force must forgo consuming a portion of what they produce. If the ratio of dependent persons to active workers goes up, the burden on active workers goes up unless the average consumption of dependents goes down.

In a physical sense, this perspective is unassailable; except for changes in inventories or the capital stock, everything consumed currently must be produced currently. But the economics is flawed. The nation as a whole may be regarded not as a single mass, but as a collectivity of successive age cohorts. Suppose that each cohort during its working life consumes less than it earns and saves the rest, and that these savings are invested productively. Upon reaching retirement, this cohort continues consuming, possibly at the same rate as during its working years. It pays for

this consumption by selling off previously accumulated assets. In what sense does this cohort of retired persons burden active workers?

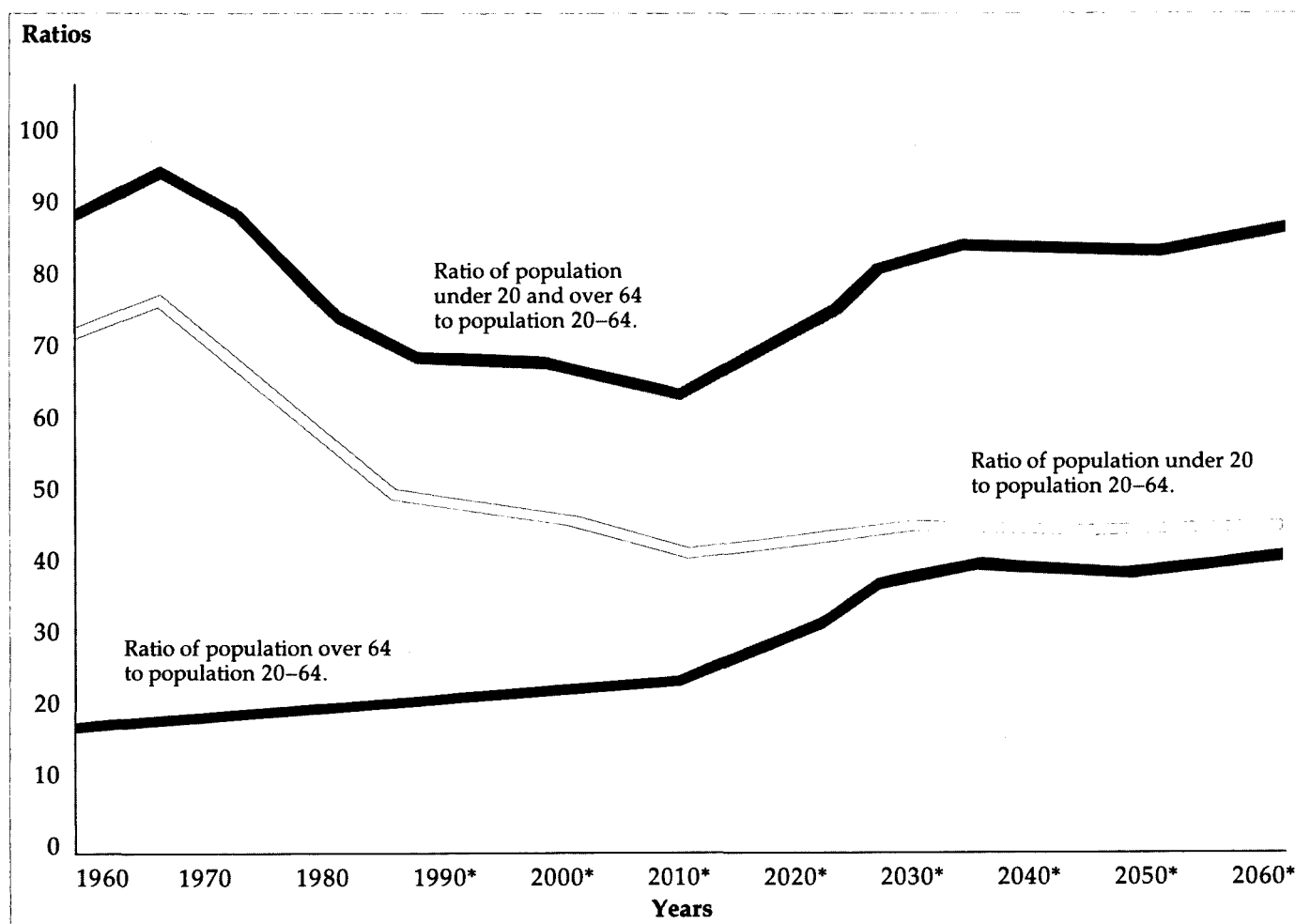
The correct answer is that it imposes no burden whatsoever. During their working years, the current elderly added to the productive capacity of the economy by their saving. They reap the benefits of this saving during retirement. Without that saving, output would have been lower than it is. The increase in output attributable to this saving just suffices to pay for the current consumption of the elderly. The nonelderly population is in the same position it would have been in had the elderly consumed everything they earned during their working years and vanished at retirement. According to this perspective, each cohort must be viewed over its life cycle. If it consumes no more than it earns in *present value terms*, it imposes no burden on other cohorts. It presents a burden only if it consumes more over its life cycle than it earned.

It is important to recognize that a cohort may be the beneficiary of transfers from other cohorts in various

ways. A cohort of the aged, for example, may receive pension benefits greater than the value of premiums or taxes it paid for those pensions. It may receive cash or in-kind transfers under income-tested assistance programs greater than the present value of taxes it paid to provide similar transfers for previous generations. Or it may receive private charity or intra-family transfers greater than the present value of those it provided to previous generations. If the elderly traditionally receive net transfers from the nonelderly, the composition of such transfers can change without any change in the amount. For example, some people argue that the excess of social security benefits over the taxes paid in the United States is partly offset by a decline in transfers from family members and from charity.

According to the cohort view, the nation-as-a-whole perspective underlying figure 1 is false, and those data are useless as a guide to the burdens any particular cohort of the elderly may or may not put on the rest of the population. Instead, the lifetime earnings and consumption,

Figure 1.
Ratio of Aged, Youth to Prime Age Adults



*Projections

Source: Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1986 Annual Report, March 31, 1986, Table A1. Projections are for Alternatives II-A and II-B.

both private and public, of a cohort must be compared to determine whether it places a burden on others. The fact that one cohort may be larger or smaller than another is simply irrelevant to this determination.

The distinction between the nation-as-a-whole and cohort perspectives may be put in another way. The nation-as-a-whole view takes the level of national income as given and examines how the proportion of that fixed income available to the people who are currently producing it changes as the dependency ratio varies. The cohort perspective takes the population as given and asks whether large cohorts save enough more than small cohorts during their productive years, thereby adding more to national output, to support the additional consumption they require when they are no longer working.

Which perspective is preferable depends on assumptions about the national saving rate. If, for one reason or another, the national saving rate is fixed, the nation-as-a-whole perspective is more useful. As one looks into the future, the cohort perspective is clearly superior, if effective instruments exist to control the national saving rate.

The Perception and Reality of Aging

It is a well-established impression in the United States that older people suffer from inadequate income, ill health, loneliness, above-average rates of crime, and other social and economic problems. In fact, older Americans are no more prone to these troubles than is any other age group; and in a number of areas they are better off than average. Some of the elderly are poor; some are ill or lonely or suffer from crime. These and other important social and economic problems deserve attention. But the elderly are not a peculiarly disadvantaged group and, with certain exceptions, their problems are not very different from those of other age groups.

The public thinks "most people over 65" suffer from "very serious" difficulties that only small minorities of the aged actually admit to experiencing (see table 2). More than half of the nonelderly and large numbers of the elderly think that "most of the elderly" are plagued by fear of crime, poor health, insufficient money, feeling unneeded, and loneliness. And nearly half think that the elderly lack medical care and sufficient job opportunities and have too little to do to occupy them. All of these problems are acknowledged as very serious by only a minority of the elderly and, in most cases, only a very small minority. Even if the elderly who characterize their problems as "somewhat serious" are included, the proportion of aged who say they experience these problems is smaller in all cases except one than the public perception.

The elderly do experience some of these problems in greater proportion than the nonelderly (see table 3). Poor health, loneliness, and fear of crime are very serious problems for a larger fraction of persons over 65 than for those under 65. But poor housing as well as insufficient money and job opportunity are very serious problems for a larger fraction of persons under 65 than for the elderly. Inadequate medical care, education and clothing as well as feeling unneeded and not having enough to do to keep busy are problems for similar proportions of both groups.

The most striking impression from a comparison of tables 2 and 3 is the perception that the elderly suffer with

particular intensity a host of problems that in reality the aged and the nonaged experience to about the same degree.³ Such data as these led one observer to suggest that U.S. policy toward the aged is hindered by five myths: that extreme poverty afflicts many of the elderly; that physical and mental disability is typical of the aged; that the elderly are financially dependent on children; that the aged withdraw from active social lives; and that the extended family plays a central and unchanged role in the support of the elderly.⁴

The rise of the elderly to approximate economic parity with the nonelderly in the United States is one of the great triumphs of social policy. This success is documented by data of various kinds. The fraction of the elderly with cash incomes below official poverty thresholds has declined far more rapidly than that of the nonelderly. In recent years, the incidence of poverty among the elderly has held constant or declined as poverty has risen among the younger population.⁵ Furthermore, these statistics, if anything, understate the relative economic position of the aged, because they exclude in-kind social assistance, which is relatively more important for the elderly than for the nonelderly.⁶ Broader measures of income point in the same direction. Recent studies of consumption opportunities indicate that, on average, the elderly are able to maintain preretirement standards of consumption.⁷ Simple comparisons of per-household incomes of the elderly and nonelderly, upon which rest the impression that the aged are economically deprived, are virtually meaningless for several reasons. Elderly families in 1984 had after-tax per capita incomes 8 percent larger than did nonelderly families.⁸ Aside from the fact that elderly families are smaller than nonelderly families, they are more likely than the nonelderly to own their own homes and to have other consumer durable goods that the nonelderly must acquire.⁹

While these data establish that the alleged poverty of the elderly as a group is a myth, they should not obscure the economic deprivation suffered by many elderly persons. Furthermore, these data are not evidence that programs such as social security pensions and medical benefits for the aged have become superfluous. The economic progress of the elderly in the United States is, in large measure, attributable to these programs. If they were scrapped or seriously curtailed, deprivation would be likely to increase.

The issue of whether the elderly are particularly burdened by poor health is extremely complex for several reasons. First and most obvious, mortality rates demonstrably rise with age, and illness usually precedes death. Second, surveys of the kind cited here are biased because they omit the approximately 1.5 million people institutionalized in nursing homes. One should include this population to gain an accurate picture of the extent to which illness is a problem of the elderly as a group. If one considers all elderly persons in hospitals or nursing homes to have "very serious" health problems, the fraction of the elderly with such problems rises.

Third, whether illness or disability is a burden is, to a considerable degree, subjective. Difficulties imposed by major illnesses or disabilities are significant; problems stemming from minor or chronic ailments depend a good deal on social and personal expectations. For example, the fraction of the population eligible for disability benefits under the social security system, the proportion of men who

Table 2.
*Perceptions and Experience
of Problems of the Aged*

Percent of population reporting problems				
Problem	Problems experienced by public 65 and over		"Very serious" problems attributed to most people over 64	
	"Very serious"	"Very serious" or "somewhat serious"	By public 18-64	By public 65 and over
Fear of crime	23%	47%	50%	51%
Poor health	21	50	50	50
Not having enough money to live on	15	40	63	59
Loneliness	12	29	61	56
Not enough medical care	10	23	45	36
Not enough education	8	25	19	25
Not feeling needed	7	19	56	40
Not enough to do to keep busy	6	17	38	33
Not enough friends	5	16	28	26
Not enough job opportunities	5	12	47	32
Poor housing	4	11	35	34
Not enough clothing	3	8	16	17

Source: Louis Harris and Associates, Inc., *The Myth and Reality of Aging in America, A Study for the National Council on the Aging, Inc.*, June 1977, pp. 31, 32, 36.

Table 3.
*Frequency of Problems
Among the Aged
and the Nonaged*

Percent of population reporting problems		
Problem	"Very serious" problems experienced personally by people	
	Age 18-64	Age 65 and over
<i>Problems experienced more frequently by the elderly:</i>		
Poor health	10%	21%
Fear of crime	15	23
Loneliness	7	12
<i>Problems experienced more frequently by the nonelderly:</i>		
Not enough job opportunities	11	5
Not having enough money to live on	18	15
Poor housing	7	4
<i>Problems for which the difference was two percentage points or less:</i>		
Not feeling needed	5	7
Not enough to do to keep busy	4	6
Not enough medical care	9	10
Not enough education	7	8
Not enough friends	4	5
Not enough clothing	4	3

Source: Louis Harris and Associates, Inc., *The Myth and Reality of Aging in America, A Study for the National Council on the Aging, Inc.*, June 1977, p. 37.

"The unmistakable profile of the elderly person is one who is in contact with other people only marginally less than nonelderly persons are and who maintains . . . contact with children and grandchildren."

are unable to perform major activities of daily living, and the number of bed-disability days per person are rising at the same time that mortality rates are falling rapidly among older persons.

It is possible that morbidity is rising because people with problems who in the past would have died are living longer. It is also possible that disability, a category that depends heavily on subjective evaluation, is rising faster than objectively measurable impairments. This second hypothesis is virtually impossible to test directly precisely because most of the data are subjective. But one careful recent effort to sift through the evidence challenged the first hypothesis that morbidity is increasing: "The most plausible interpretation of the different pieces of evidence is that average health and ability to work have improved, but that in recent years a much larger fraction of the disabled have applied for and been awarded benefits than was true 20 or 30 years ago. The changing social attitudes that brought this about also increased the self-reported incidence of severe activity limitation."¹⁰

Although the willingness to declare health a problem may be rising, there is no indication that it is rising more or less for the aged than for other groups. The incidence of poor health is higher among the elderly than among the nonelderly and increases with age. But the overwhelming majority of the aged, like most of the nonaged, are free of disabling physical impediments.

The belief that the elderly are isolated from other people

and dependent financially on their children is contradicted emphatically by the survey cited earlier. Again, one must recognize that the institutionalized population is not covered in surveys. The proportion of persons 65 or older who spend "a lot of time" socializing with friends or participating in recreational activities or hobbies is only slightly less than among people aged 18 to 64. More than four-fifths of the aged report that they have seen their children within the past week; nearly three-quarters have seen their grandchildren with the same frequency. Nearly half of the elderly say they help children and grandchildren out with money, and more than one-third of persons 18 to 64 acknowledge such gifts.

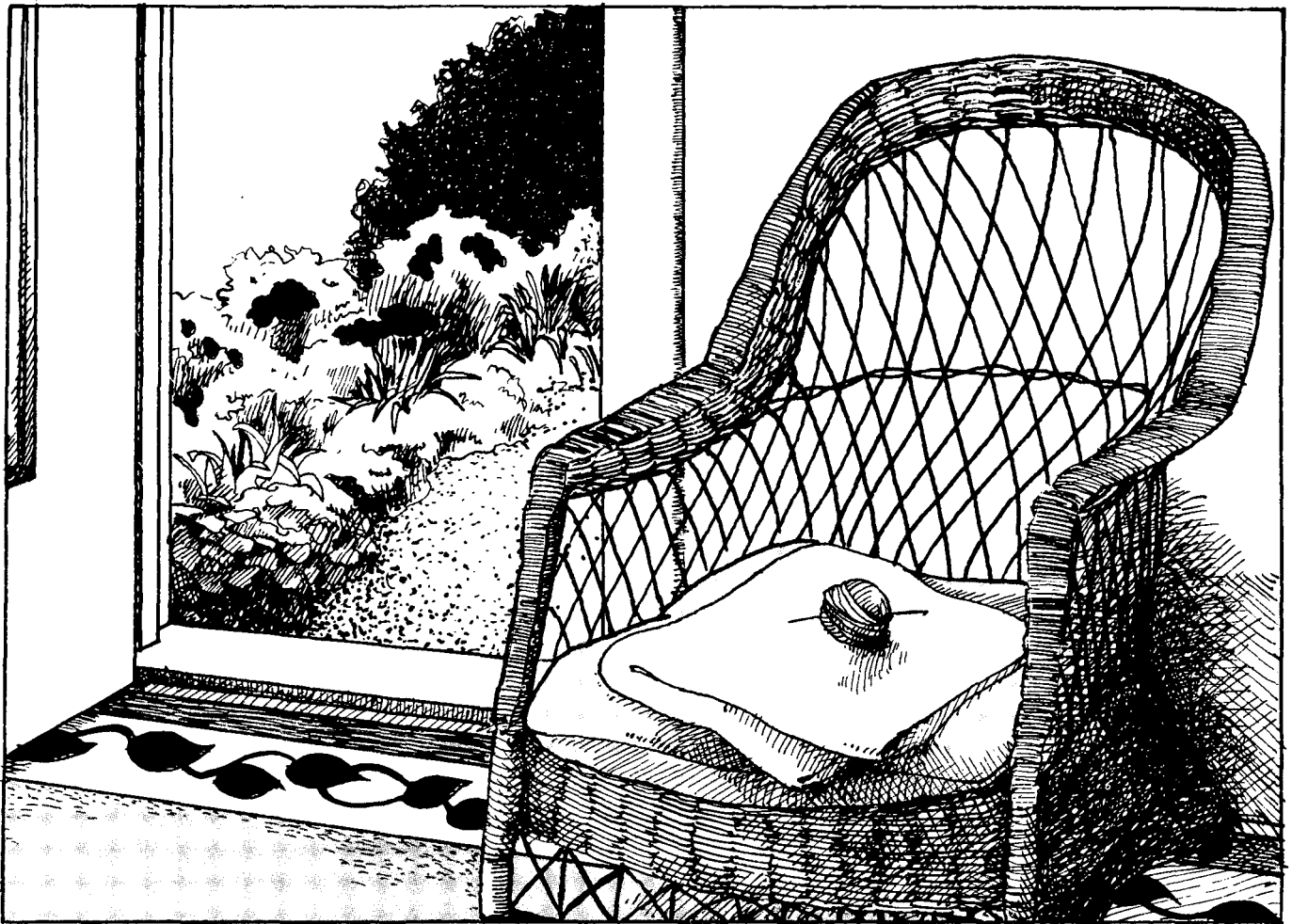
The unmistakable profile of the elderly person is one who is in contact with other people only marginally less than nonelderly persons are and who maintains reasonably close contact with children and grandchildren. Again, these statistics do not deny the existence of many lonely or isolated elderly people; they merely suggest that the relative frequency of such problems is not materially greater among the elderly than among younger adults.

While the elderly maintain contact with others, including their children, in the United States they typically are not part of an extended family. They live as couples or unrelated individuals, a pattern that seems to be a matter of choice, according to a recent study.¹¹ While the relative incidence of independent living has increased, it is unclear whether the extended family was ever the norm in the United States.¹² In any event, the sense of financial responsibility for one's parents has diminished. In 1957, 52.5 percent of the population said that adult children should provide financial support for aged parents; by 1974 this fraction had fallen to 10.3 percent. It is not clear whether this shift in attitudes was caused by the growth of social security cash benefits and private pensions, whether the rise of these benefits was attributable to this change in attitudes, or whether there was some kind of complex inter-relationship among trends in attitudes and the rise of programs like social security.

Speculations on Future Trends

Public policy debates about the aged must consider the following: workers have been moving toward ever earlier retirement. The elderly have become increasingly independent of financial support from children. The social security pension system grew more or less steadily as measured by the ratio of benefits to average wages from 1950 to 1977; and coverage was extended monotonically from 1950 until 1984. The natural limit of coverage, all of the labor force, has nearly been reached; and the budgetary and political situation make any perceptible increase in the ratio of benefits to previous earnings extremely unlikely in the next five to ten years.

The current policy debate does not concern extension of public pension and other benefits, but whether and how it might be possible to reduce the cost of public pensions. Under the pressure of the presidential campaign, President Reagan in 1984 declared that he would resist any cuts in social security pension benefits; but he reversed that position as debate over the 1986 budget unfolded. He has proposed cuts in pensions for public employees all along. Furthermore, changes in the tax system have increased



incentives for individuals to set up savings accounts that cannot be drawn upon before age 59, except in certain circumstances or following payment of a special 10 percent tax. Current tax proposals would curb but not eliminate these saving incentives. As the number and size of these accounts increase and as coverage and benefits under private, employment-based pension plans rise, pressure may be renewed to curtail the social security system in some fashion.

A major focus of debate in the United States concerns how to preserve employment opportunities for older workers who wish to remain active while, at the same time, facilitating the retirement of others. Until 1978, when Congress amended the Age Discrimination in Employment Act, many U.S. employers required workers to retire at 65 or earlier. Now, except for narrow categories of managerial workers, most employees cannot legally be forced to retire before age 70. Nevertheless, the trend toward early retirement has continued. To encourage people to extend their working lives, Congress in 1983 increased to 67 from 65 the age at which full social security benefits are paid. This step can only be characterized as symbolic, however, as the effective date for the increase was set in the twenty-first century.

From an economist's point of view, one of the most important issues concerns how the large future social security obligations will be paid. Under the 1983 social security amendments, for the next three decades revenues from

taxes imposed on workers and their employers will be larger than the total benefits paid to the retired and disabled, and a large surplus will accumulate. If other federal taxes covered all other federal expenditures, this social security surplus could be used to retire much of the outstanding national debt, thereby releasing resources for private investment. By adding to the productive capacity of the nation, this investment would defray much or all of the increased costs of social security benefits when the number of retirees increases. In short, current U.S. social security policy seems to be modeled on the cohort perspective of social security burdens.

There are two problems with this interpretation, however. First, federal taxes other than those levied for social security cover only about 70 percent of all other federal spending. Unless these deficits are eliminated, the social security surpluses will serve merely to reduce the drain of the federal budget as a whole on private saving. Unless some other means is found to close the federal deficit, no addition to capital formation from social security surpluses can result.

Second, while taxes imposed to pay for social security pensions far exceed projected pension benefits for three decades, taxes levied to pay for health care for the elderly and disabled are expected to fall short of the cost of these programs. Thus, the surpluses of the pension programs will be absorbed in part by another program serving the aged and disabled, unless the deficits in the health pro-

grams are prevented from occurring.

Rising health care costs, however, do not solely, or even primarily, concern health programs for the aged. Rather, they reflect technological advance and open-ended financial support for health costs through private insurance as well as public programs. The rapid increase in health costs is the most important fiscal development affecting the public programs for the elderly; but it cannot be approached intelligently if policy-makers try to deal with it solely within the context of programs for the elderly. Policy-makers should reconsider how *all* hospital care is paid for and then remake programs serving the elderly within those guidelines.

All developed nations face a profound dilemma—to bear the rapidly increasing costs of providing ever more sophisticated hospital care to aging populations or, alternatively, to ration care, and in so doing deny some potential benefits to some patients. Some savings, possibly large in absolute amount, can be achieved by eliminating services such as unnecessary hospitalization or idle equipment that provide no medical benefits at all and by improving the efficiency with which beneficial services are produced. But these savings can be achieved only once. After they have been reaped, the source of the rising trend in medical outlays—the technological transformation of medical care—will reassert itself. At that point, the dilemma—pay the bill or ration services—will have to be faced.

The sharp growth in the population over age 65 is being preceded by rapid increase in the number of the very elderly. This demographic fact implies large calls on health care and social services of a particular kind, namely long-term care, nursing home care, and home health services. Recent evidence suggests that home health services are at

least as costly as institutional care, once the displacement by public home health care of services otherwise provided privately by friends and relatives is taken into account. Social services include visitors, social work, and food services. Meeting the costs of such services will place significant burdens on private and public budgets. Few of the elderly set aside funds to deal with the costs of long-term care, and little private insurance is available to assist in meeting these costs. Public programs run the risk of drawing in people who, but for the public program, would manage independently or with the aid of relatives and friends. To date, the United States has not figured out how to deal with the diverse problems of the frail aged in a compassionate and economically efficient way.

1. The proportion of women in the labor force rose from 33.9 percent in 1950 to 54.9 percent in 1985; it is projected to rise to 58.6 percent in 2000 before beginning to fall. The labor force participation rate for men dropped from 87.3 percent in 1951 to 76.6 percent in 1983. It is projected to climb back to 79 percent in 1990 as the baby-boom generation moves through its prime working years and then to drop below 70 percent by 2030. The observed labor force participation rate is projected to fall from a historic high of 68.2 percent in 2000 to 59.4 percent in 2050. *Economic Projections for OASDI Cost and Income Estimates, 1984, Actuarial Study No. 94* (Department of Health and Human Services, Social Security Administration, Office of the Actuary, January 1985). The projections reported here and in the text are for projection II-B.

2. Data are from unpublished statistics of the Bureau of Labor Statistics, Department of Labor, March 5, 1984. Statistics are projections for 1986.

3. The source does not report whether the misperception of problems of the nonelderly is as serious as the misperception of the problems of the elderly.

4. These myths are obviously related to one another and, to a degree, contradictory. For example, it would make no sense to speak of extreme poverty among the elderly if the extended family were the dominant context within which the elderly derived economic sustenance. See Stephen Crystal, *America's Old Age Crisis: Public Policy and the Two Worlds of Aging* (Basic Books, 1982); and Fay Lomax Cook, *Who Should Be Helped? Public Support for Social Services*, Sage Library of Social Research, volume 83 (Sage Publications, 1979).

5. U.S. Bureau of the Census, Current Population Reports, Series P-60, No. 137, *Characteristics of the Population Below the Poverty Level: 1984* (Government Printing Office, 1985), Table 1, pp. 5–7.

6. U.S. Bureau of the Census, Technical Paper No. 50, *Alternative Methods of Valuing Selected In-kind Transfer Benefits and Measuring Their Effect on Poverty* (Government Printing Office, 1982); see also Sheldon Danziger et al., "Implications of the Relative Economic Status of the Elderly for Transfer Policy," in Henry J. Aaron and Gary Burtless, eds., *Retirement and Economic Behavior* (Brookings Institution, 1984), pp. 175–96.

7. Laurence J. Kotlikoff et al., "The Adequacy of Savings," *American Economic Review*, vol. 72, no. 5 (December 1982), pp. 1056–70.

8. Nancy Gordon, Statement before the Subcommittee on Health and the Environment, Committee on Energy and Commerce, U.S. House of Representatives, March 26, 1986, p. 3.

9. Danziger, "Implications of the Relative Economic Status of the Elderly for Transfer Policy."

10. Martin Neil Bailly, "Aging and Ability to Work: Policy Issues and Recent Trends," paper presented May 2, 1985, at a Brookings Conference on Retirement and Aging.

11. Saul Schwartz et al., "The Choice of Living Arrangements," in Aaron and Burtless, eds., *Retirement and Economic Behavior*, pp. 229–54.

12. Crystal, *America's Old Age Crisis*.

*"All developed nations face a
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Missed Opportunities in the Middle East

IN FEBRUARY 1986, a yearlong effort to find a solution to the Palestinian-Israeli conflict collapsed. The Review recently invited two Middle East Studies fellows — an Israeli and a Palestinian — in the Brookings Foreign Policy Studies program to discuss why this latest attempt failed and what the future might hold. The scholars are:

Moshe Ma'oz — Chairman of the Department of Islamic and Middle East Studies at Hebrew University in Jerusalem from 1984 to 1986, Ma'oz in 1985 also was a member of a think tank that advised Israeli Prime Minister Shimon Peres on Arab-Israeli relations. Ma'oz served as an adviser to Israeli Defense Minister Ezer Weizman in 1979–80 and to the Israeli Knesset Committee for Foreign Affairs in 1977–79. His most recent book is *Palestinian Leadership on the West Bank*. Ma'oz is currently finishing a political biography of Syrian President Hafiz al-Asad and is preparing a study on Syrian-Israeli relations since 1948.

Emile Sahliyyeh — An associate professor of political science in the Department of Middle East Studies at Birzeit University in the West Bank, Sahliyyeh was an International Security Studies fellow at the Woodrow Wilson International Center for Scholars before coming to Brookings. He is the author of *The PLO After the Lebanon War* and is currently completing work on another book entitled *Political Processes and Dynamics in the West Bank*.

The discussion was moderated by Martha V. Gottron, editor of *The Brookings Review*. The following is an edited version of that conversation.

Broken-Off Talks

Review: In February 1985 King Hussein of Jordan and Yasir Arafat, chairman of the Palestine Liberation Organization, reached an agreement to move together to seek a negotiated settlement of the Israeli-Arab conflict based on the following principles: Israeli withdrawal from the West Bank and Gaza; recognition of the right of self-determination for Palestinians within the context of a confederation of Jordan



Moshe Ma'oz



Emile Sahliyyeh



"So what happened . . . when King Hussein broke off his talks with Arafat was . . . the natural outcome to an American policy of disinterestedness, an unwillingness to engage itself actively in the search for a political solution."

with the West Bank and Gaza; and the formation of a joint Jordanian-Palestinian delegation to enter negotiations under the auspices of an international peace conference and on the basis of pertinent UN resolutions. Among these was UN Security Council Resolution 242, which stipulates that Israel should give up the lands it seized during the 1967 war in return for secure borders and recognition by its Arab neighbors. Some progress seemed to be made over the next months. But then in February 1986, Hussein announced that he had broken off talks with Arafat. What happened, Emile?

Sahliyeh: If one looks back starting in the summer of 1985, and especially after King Hussein's visit to the United States in September, it was more or less clear that the Reagan administration was not interested in reactivating its search for a political solution in the Mideast. On October 1, the Israeli government launched an attack upon the PLO's headquarters in Tunis, which made it difficult for the PLO to try to come more openly toward a political settlement. The hijacking of the Achille Lauro by a militant faction of the PLO

happened on October 7, and about a week later the PLO representatives in the joint Palestinian-Jordanian delegation failed to meet in London with the British foreign minister, a move that angered Hussein. In November there was the crisis in Israel when Prime Minister Shimon Peres tried to dismiss [Cabinet Minister and Likud party member] Ariel Sharon. Peres backed down, which convinced Hussein that it was not the time to embark upon a political settlement because Peres was politically weak. Then in December you had the terrorist attacks in the Vienna and Rome airports.

So what happened on February 19 when King Hussein broke off his talks with Arafat was more or less the natural outcome to an American policy of disinterestedness, an unwillingness to engage itself actively in the search for a political solution. It was also a reaction to the PLO's unwillingness to recognize [UN Resolution] 242. And finally, it was a natural reaction of King Hussein who is concerned about surviving politically, especially in the wake of his reconciliation with Syria.

Review: Moshe, do you view the situation differently?

Ma'oz: Not really, but I would like to approach it in a slightly different way to find and weigh the prospects for peace vis-à-vis the constraints. To first speak about the prospects, I think the major parties to the conflict and some other participants had, and still have, a stake in the success of the peace process. This is the bright side. First, I would mention the Israelis, not all of them, unfortunately, but certainly Prime Minister Peres and most of his Labor party. I think the Israeli people, most of them, don't want to control another nation, but they do want a solution that will ensure national security. And they don't want to end up with a binational state of one people controlling another people, which has a corrupting effect on Israeli society. They see this first as a Jewish problem, not just a Palestinian problem. Will Israel be a Jewish democratic state or a binational state or a South African type of state? But again, the main consideration for most Israelis is security.

The same goes for the Palestinians. I think many Palestinians, most Palestinians, hopefully, would like to have a political solution. They would like to have a kind of settlement where they can have self-determination in the form of a state or a federation or confederation with Jordan. I speak mainly about the West Bank people, not necessarily about the PLO. The West Bank people, I think, have a stake in coexistence, not because they like Israel, not because the Israelis love the Palestinians, but because of the necessity to live together. The alternatives are worse. The alternatives are annexation or war. The Palestinians will be greatly affected in either of these scenarios, and they will suffer.

I wish also to say that, for its own vital interests, the Kingdom of Jordan would like to have a peaceful coexistence with Israel and a solution to the Palestinian problem. Egypt also would like to have a political settlement of the Palestinian question because a solution to this problem is still the litmus test of genuine Arabism, and Egypt wishes to recover leadership of the Arab world.

These are very briefly the prospects. But there are also constraints, very grave constraints, which might neutralize the prospects. To start with, in Israel you have the right-wing Likud party, which is part of the coalition government. The Likud doesn't believe in a solution whereby the West Bank and Gaza will be handed back to the Palestin-

ians or to a Palestinian-Jordanian confederation. Likud members think that security can be maintained only if Israel controls the West Bank and Gaza. Many of them also have religious, historical, and nationalistic motivations for controlling these territories. And in October 1986, Likud leader Yitzhak Shamir, the foreign minister now, will replace Peres as prime minister in the coalition government. And I think he may go ahead with annexation. So the summer of 1986 is very crucial because if the Likud party comes to power, although it will not control the entire government, it may have its way in annexing the West Bank, and this would further hurt peace prospects.

Then there is the PLO. The PLO represents the Palestinian people and its legitimate rights, but in my opinion, the PLO doesn't represent those interests in the best way. True, Arafat signed the February 11, 1985, agreement with King Hussein. It was a good agreement, I think, because it contained some very forthcoming expressions such as "land for peace," which amounts to implicit acceptance of UN Resolution 242. Unfortunately, the PLO has not been explicit in recognizing Israel. And, at any rate, Arafat is unable to fulfill his part of the confederation agreement. It seems to me that Arafat prefers to have his organization intact rather than to solve the Palestinian problem. Now, since the PLO is considered the only representative of the Palestinian people, Israel has to negotiate with the PLO. But Israel will not speak to the PLO as long as the PLO doesn't end its terrorist activities and doesn't explicitly recognize Israel. Consequently, the PLO position is still a very big obstacle to peace.

Another major obstacle is Syria. Syria, Libya, and Iran form an unholy trinity of countries who are blocking any peace settlement. In our context, Syria is the country that is sabotaging any effort for peace. She was instrumental in splitting the PLO and controls its rejectionist wing. She neutralized the rapprochement between the PLO and Jordan by entering into a Syrian-Jordanian agreement that in effect abrogates the agreement between Arafat and Hussein. Syria doesn't want a solution to the Palestinian problem that doesn't follow her line.

Mutual Recognition

Review: Emile, it does appear that the PLO unwillingness to accept 242 is a main stumbling block in moving the peace process forward. Is there any way around this? Is it unfair to expect the Palestinians to make the first move?

Sahliyeh: I don't think it's really the question at this point. In February of this year, the PLO was prepared to accept the UN Resolution 242 in return for an American acceptance of the Palestinian right for self-determination. The Americans refused that, even though the PLO's demand was not for a fully independent Palestinian state, but for a confederation of the occupied territories, the West Bank and the Gaza Strip, with Jordan.

Unfortunately, the Reagan administration was not at all willing to accept even that modification. Now, given that kind of American opposition and given also Israel's opposition to accepting a Palestinian national right to self-determination, I think it is very difficult to imagine how Arafat could come and say, "The PLO will also recognize 242," without receiving any concessions in return. After all, he has to try to justify his acceptance of 242 to his own constitu-

ency. And if one looks back at the reaction to the failure of the Jordanian-Palestinian dialogue on the West Bank, it's clear that the majority of West Bank Palestinians supported the position adopted by Arafat that he wouldn't simply accept 242 without any political concessions in return. Without an acceptance of some form of Palestinian right to self-determination, I don't think we are going anywhere. We will continue to be in a deadlock situation.

Now there is the other problem, which is whether the PLO can be the only one to represent Palestinian interests or not. I think some sort of formula has been found in the Jordanian-Palestinian negotiation team, that is, that there would be a joint team drawn from Jordanians as well as Palestinians from the occupied territories and outside the occupied territories, not necessarily prominent PLO members, that will represent Palestinian interests.

But the stumbling block again is the lack of recognition by the United States of the Palestinian national right to self-determination. This is an indication of American unwillingness, reluctance, disinterestedness to pursue a policy of settlement. And there was a chance, especially after the signing of the February 1985 accord between Arafat and Hussein, to achieve a political solution.

The United States did not grasp that chance. One cannot expect Shimon Peres to grasp that chance because of the PLO's involvement. But at least the United States should have operated as a broker, as a mediator between the Israelis, Jordanians, and Palestinians, should have tried to bring them together to reconcile their antagonism, their opposing views. The February 1985 agreement would probably have had a better chance of success. I mean, if you look back, it wouldn't have been possible to sign the Israeli-Egyptian peace treaty of 1979 without the intensive efforts by the Carter administration. The gap was so wide between the Israelis and the Egyptians, and it was only through intense American efforts that the gap was bridged.

Review: Moshe, what is the U.S. role from your viewpoint? **Ma'oz:** I think that essentially the parties which are at war, in conflict, are Israelis and Palestinians. And although I don't disagree that the United States will have a role as a broker, and Egypt too, it shouldn't be at the expense of direct negotiations between Israelis and Palestinians. They must speak to each other because they happen to live on one land. There are 1.5 million Palestinians on the West Bank and the Gaza and they are going to remain there. The Israelis have to recognize their rights as a people.

This brings me to the question of mutual recognition. The PLO does not recognize Israel explicitly but accepts implicitly Resolution 242 in line with other UN resolutions that blame Israel and equate Zionism with racism. Israel won't accept that. Israel has got a right to be recognized fully as a sovereign state. Because of the PLO refusal to recognize Israel, many Israelis have deep suspicions that the PLO wants to take over Israel proper, that it won't be satisfied with a West Bank-Gaza state. Many members of the PLO, unlike the West Bank and Gaza people, originally come from Israel proper and they want to go back. It's not only ideology, it's a strong personal motivation and indoctrination. And as long as this attitude persists, Israelis will suspect that the PLO is not going to accept Israel's existence. As evidence, these Israelis cite terrorist activities by the PLO directed not only against Israeli military targets, but against civilians, including women and children.

"The Palestinians deserve a state provided it is not at the expense of Israel and Israeli security. . . . Let's start with an entity linked to Jordan and for five, ten years, fifteen years, see how it works. This entity — the West Bank and Gaza — should be demilitarized and subject to partial Israeli military supervision for a time. And if this solution works . . . let the Palestinians have a state."



Taking the Initiative

Sahliyah: Why wouldn't Israel recognize the Palestinian right to self-determination? Why so far has Israel completely avoided talk about Palestinian self-determination? Palestinians are equally suspicious that Israel does not intend at all to give up the West Bank and the Gaza Strip. Over the years, even between 1967 and 1973 when Jordan claimed to speak for the West Bank, the Israeli Labor government, which was in power at the time, did not respond. It did not respond favorably to King Hussein's federation plan in 1972. Ten years later, in September 1982, the Likud government categorically rejected the Reagan initiative, which advocated self-government for the Palestinians in the occupied territories in association with Jordan. So the Palestinians believe that the Israelis do not intend to give up the occupied territories.

And it seems to me that because Israel is more powerful, why wouldn't it take the initiative and recognize the Palestinians' right to self-determination within the confines of confederating or federating the West Bank and the Gaza Strip with Jordan? If the PLO did not accept this offer, it would be left out. And then West Bank Palestinians would face a new situation. People would face a choice: Either you take the Israeli offer or the land will be annexed or the occupation continued. West Bank Palestinians who want to end the occupation will have to make a choice. And I think they would go ahead and reach a settlement between Israel and Jordan and themselves.

Ma'oz: It is true that Israeli officials did not recognize the rights of the Palestinians until 1973. Golda Meir herself said that there is no Palestinian people. But in 1974 Prime Minister Yitzhak Rabin did say that he recognized the rights of the Palestinian people. Furthermore, even Mr. Begin himself in the Camp David Accords agreed that the Palestinians should participate in determining their future. Begin aside, the Israeli Labor party recognizes the right of Palestinians to self-determination, but within a restricted definition. The party doesn't want a Palestinian state. It is willing to recognize the Palestinians' rights within a federation with Jordan.

Sahliyah: But why don't they come out and say this is their position? I believe that the Israelis have always been asking the Palestinians to make the first move. Sadat came to Jerusalem. Why shouldn't the Israelis come and say, "We recognize Palestinian interests, national rights, within the limitations of confederation with Jordan"? And then you would have a totally different political dynamic.

Ma'oz: It's true. I agree with Emile that Peres should stand on the podium of the Knesset and say it in so many words. He should declare that he is willing to talk to any Palestinian group, including the PLO, which recognizes Israel and renounces terrorism.

Still, even the confederation agreement between Jordan and the PLO was open to different interpretations. According to Arafat's interpretation, there should be a Palestinian state, not just an entity, confederated with Jordan. The PLO did not give up the idea of a state. This doesn't worry me. The Palestinians deserve a state provided it is not at the expense of Israel and Israeli security. Now, since we have had this conflict with the Palestinians for a century, we cannot overnight create a Palestinian state. Let's start with an entity linked to Jordan and for five, ten years, fifteen

years, see how it works. This entity — the West Bank and Gaza — should be demilitarized and subject to partial Israeli military supervision for a time. And if this solution works, and there are good relations between Israel and the Palestinian entity, let the Palestinians have a state. We badly need this interim period since many Israelis worry that the PLO really would use this territory as a springboard to attack Israel.

Sahliyah: Let me address the question of the PLO carrying out terrorist activities. Now, if there is a West Bank-Gaza Strip autonomy linked with Jordan and the Israelis withdraw, I believe that the Palestinians on the West Bank and the Gaza Strip would be extremely concerned not to upset the new status quo. They would not allow terrorist activities to be launched because what does it take for Israel to reoccupy the West Bank and the Gaza Strip? Ten minutes, fifteen minutes, before they could be reoccupied. So to just give up or sacrifice their aspirations for so many decades, to get Israeli occupation ended for the sake of launching a military operation here or there will definitely be suicidal and they will have to avoid it. West Bank Palestinians will not allow terrorist activities of this sort.

Review: How will they prevent them?

Sahliyah: There would be certain measures on the border like UN troops. You have to take these security measures on the borders between the West Bank and Gaza and Israel. And with time things will be normalized. A peace treaty would have to be signed between the Palestinians, Jordanians, and Israelis. Cultural and diplomatic, economic relations will have to be set up. I'm sure many West Bank and Gaza Strip Palestinians would be employed inside Israel. There would probably be joint economic programs to develop the West Bank. So all of these things would have to take place in the context of a political settlement. In order to try to stop terrorist activities against Israel — that is a phenomenon that is not easily stopped — it will be helpful to have the Syrians engaged in the political solution, because then you reduce the Syrian incentives to work against a settlement.

The Syrian Factor

Review: How likely is it that the Syrians would join in peace negotiations in a sincere way?

Sahliyah: I don't know. People in the United States tend to think of the Syrians as being militant and tough, but if you really look at the Syrian record between 1973 and 1986, the Syrian-Israeli border has been the quietest. Syrians have been very careful to observe the cease-fire with the Israelis. Syrians cooperate when it is to their interest. They've cooperated with the United States. If the Syrians are given a proper role and if their grievances are acknowledged, I don't think they will be against a political solution.

Ma'oz: The core sentence that you said is, "if it suits their own interest." I'm not sure that the Syrian interests are to have this kind of Jordanian-Palestinian-Israeli solution.

Sahliyah: The Syrians are important. They wouldn't be against it.

Ma'oz: I'm not sure. Ultimately, the Syrians should be involved in the settlement because I agree with you that a comprehensive settlement should be introduced to the Middle East. But, as we know, the Syrians are not the best friends of the Palestinians. Take the case of Tel Za'tar in 1976



"... because Israel is more powerful, why wouldn't it take the initiative and recognize the Palestinians' right to self-determination . . . ? If the PLO did not accept this offer, it would be left out. And then West Bank Palestinians would face a new situation. . . . Either you take the Israeli offer or the land will be annexed or the occupation continued. . . . And I think they would go ahead and reach a settlement. . . ."

and other incidents in Lebanon. The Syrians killed more Palestinians than anyone else. In order to prevent the Syrians from spoiling a political settlement, a wider Arab coalition, including Iraq and Saudi Arabia, is needed.

Alas, I'm not sure whether such a coalition would work. But as an Israeli, I must say that Israel should do everything to pursue this peace process with the Palestinians because the onus is on Israel. We have 1.5 million Palestinians under Israeli control. And this situation, if left unsolved, is going to affect the ethical character of the Jewish state, especially if Israel annexes the territories.

The major problem is that Israel doesn't have a credible Palestinian partner to negotiate with. We know that, in the past, Palestinian leaders in the West Bank and Gaza and even within the PLO itself who tried to negotiate with Israel were assassinated. This is really the tragedy of the Palestinians. A moderate Palestinian who tries to negotiate with Israel is likely to be killed by militant Palestinians. This was the fate of Sa'id Hammami, Isam Sarrtawi, Fahd Qawasmeh, and Zafir al-Masri.

Sahliyyeh: If I may interrupt you, that's why we definitely need some sort of political statement on the part of Israel, because so far the moderates who are willing to recognize Israel, what are they getting in return? At least if there is an Israeli offer, then these moderates have something to rely upon. The political composition inside Israel at this point does not allow that kind of offer. But I believe also that it is the Israeli society and the Israeli people who have to decide what kind of Israel they want in the future. Do they want to continue to be isolated in the Middle East or do they want to be integrated into the Middle East?

And they also have to live and let live. Unfortunately, the tendency that is growing in Israel is towards the religious right fanaticism and this also is creating a counterresponse within the Palestinian society. We have nowadays a rising Islamic fundamentalist movement among the Palestinians. And if on both sides you have religious fanaticism, then I believe there would be no room for compromise. So I agree with Moshe that both the Palestinians and the Israelis are faced with crucial choices that they have to make at this point or the future will be quite alarming.

Ma'oz: I couldn't agree more. I think there are extremists on both sides and they enhance one another, and we can end up with a bloodbath between the two communities. So it's a time for the moderates, the pragmatists, to take over and to strike a deal. The alternative is terrible. This is a historic juncture for Israelis and for Palestinians as well.

Need for Active U.S. Involvement

Sahliyyeh: That's why I believe that the United States can be helpful. If, for instance, the U.S. were to say it recognizes Palestinian national rights on the basis even of the 1982 Reagan initiative, which is more or less in line with the agreement Hussein and Arafat reached a year ago, if the administration were to come out openly on this, it would encourage Shimon Peres also to come forward and face the political opposition inside Israel. And Hussein would come forward. Hopefully, West Bank Palestinians and the PLO would come forward. This would bring down the Israeli government, and the people would have to go for elections. And if the Israelis are faced with the possibility of peace, I would think that they would choose a government that

would fulfill the dream of peace rather than electing the Likud or the extremist, rightist groups. You need a catalyst.

You see, both Peres and Arafat are weak. They are weak, and if you are weak, you cannot take the lead. I'm sure both of them are convinced they have to recognize each other's rights. But because of their political weakness and because of their natural instincts for political survival, they simply cannot do it. And that's why a catalyst is needed — to help West Bank Palestinians, to help Jordan, to help Shimon Peres come to common grounds. And I'm very positive that once that initial step is taken, many Israelis don't want to continue living in isolation. They want to have peace.

Review: In other words, in your view, Reagan should reinvigorate his 1982 initiative?

Sahliyyeh: I wish he would, but he is not willing. He doesn't want to do it. Period. This administration doesn't have any policy for the Middle East. It's as simple as that. If it were the Carter administration, I'm sure totally different results would have been achieved because, unlike 1977–78, Jordan is willing. The PLO, whether it is sincere or not, at least has committed itself to a political solution of the problem based on a confederation of the West Bank and the Gaza Strip with Jordan. The PLO is no longer insisting that it is the only one who should represent Palestinian interests. In 1977 and 1978 that was not the case. Then the PLO wanted to be the only one who could speak in the name of the Palestinians, and it would not give up the idea of an independent Palestinian state.

That's why the Reagan administration should have utilized the opportunity presented by the Arafat-Hussein agreement. It was not the best formula for achieving political settlement, but at least you had something you could have started with and seen where it would go.

Review: Emile, earlier you said that the Israeli government should acknowledge the Palestinian right to self-determination. What happens if Israel should make this move and the PLO refuses to recognize Israel in return?

Sahliyyeh: According to people who were involved in the negotiations between King Hussein and Arafat, failure of those talks in February came particularly and explicitly because Jordan insisted on PLO recognition of 242. The PLO said it would recognize 242 provided that the U.S. recognized the Palestinian right of national self-determination. The U.S. did not accept that. So if what was conveyed to us is true, then if the Israelis were to recognize the Palestinian right of self-determination, there is no reason for the PLO not to accept it.

But if the PLO were to reject it, which I really doubt at this point, then it would be a different case. The West Bank's leadership will say, "If you reject it, why do you reject it?" There will have to be a debate within the Palestinian community about why the PLO rejected the Israeli offer. And I believe that then the West Bank Palestinians will have to attend to their own concerns, and I think they will. Israel has to provide the opportunity by accepting the Palestinian right to self-determination and see how the PLO reacts. If it doesn't react positively, then I honestly believe that the West Bank Palestinians will depart from the PLO.

Ma'oz: I agree with this, but I still maintain that the PLO is cynical. Cynical or inhibited, because the PLO had a different interpretation than Jordan had of the proposed confederation. Secondly, why should the PLO not accept explicitly 242? What does it take? Chairman Arafat should

publicly say, "We are willing to recognize Israel, to abolish terrorism, to abolish the PLO national charter [which calls for the destruction of Israel] in return for recognition by Israel of Palestinian self-determination." If you require Peres to do it, why shouldn't Arafat do the same? I admit that the chances for Israel to make this move are perhaps better than for the PLO, because the PLO has a lot more constraints.

But it's not helpful if only one side makes a gesture. Each side has to make the move to reassure the other side. It's a kind of traditional vicious circle, a psychological barrier, a catch-22, and they have got to get out of it. For Israel it would be very helpful if the PLO would come forward and say in so many words "We are not going to use violence any longer. We want to coexist with Israel and have only part of Palestine."

Review: Moshe, what is likely to happen if the United States does in fact make some formal statement recognizing the Palestinian right to self-determination?

Ma'oz: First, I would like to say that the State Department begged Arafat to make this declaration about 242, but he wouldn't. Still I think that the United States could act as an important broker between the parties. But the United States, like many Israelis, wants to make sure that Arafat means business. And I think it's legitimate on the part of the Reagan administration to require the PLO to recognize 242 before the United States backs self-determination—this is the only condition. The U.S. said to the PLO, "You recognize 242, then we are willing to talk to you and to help you to negotiate." I think it's a very reasonable, sensible request on the part of the United States.

Sahliyh: Up until now the United States has rejected accepting the Palestinian national right to self-determination. And that is one of the crucial issues. Now, assume that the United States recognizes the Palestinian national right to self-determination, obviously the Israelis would be upset. But this does not necessarily commit the Israelis. At least it initiates the process, and from there on the parties can work on defining, limiting, constraining their right for self-determination in line with the Reagan initiative.

But in the last two months, the United States refused to acknowledge Palestinian rights within the context of the Reagan initiative. The Reagan administration has a simplistic perception of the world; that you have a good force and an evil force. The good force is represented by the United States. The evil force is the Soviet Union and its protégés. The Reagan administration associates the PLO and Syria with the Soviet Union. The primary goal of the United States in the Middle East is to contain that evil force, communism, rather than trying to attend to a regional conflict. It's that simple. The Arab-Israeli conflict is just not a priority for them.

Plus, even though the conflict isn't solved, still the United States is continuing to do business with the Arab world. The price of oil is coming down. Why should the U.S. do anything? The Arab regimes are certainly dependent upon the United States, whether or not the Arab-Israeli conflict is resolved. So there is no pressing need for the Reagan administration to do something immediately. But this is obviously a shortsighted policy and in the long run, I believe both the Palestinians and the Israelis as well as the Americans will suffer if they continue to just hope for a political solution.

Ma'oz: I agree that the United States has to be more active, but I think there also is a role for Egypt to play here. Egypt is the most powerful Arab country. Egypt has got good relations with the parties involved. Not with Syria, but with Jordan and Israel, with the Palestinians, with the PLO, with Iraq. Alas, Egypt's leadership is also weak, President Mubarak is weak. Other Middle East leaders are also weak, but with U.S. encouragement they must make a coordinated effort. This is because of the common menace, the danger of this unholy coalition of Khomeini's Islamic fundamentalism and Libyan and Syrian militancy. If, God forbid, Khomeini is able to break through the Iraqi line, the whole Middle East is in danger. One way to block this fundamentalist threat is to reach a political settlement among the moderate-pragmatic parties in the region. Otherwise all of us, Arabs and Israelis, are going to be exposed to the Islamic fundamentalist peril.

Review: So both of you are pessimistic that a solution will be found soon?

Ma'oz: Pessimistic, but hopeful that pragmatism and reason will prevail.

Sahliyh: There is no reason for optimism.

"I think there are extremists on both sides and they enhance one another, and we can end up with a bloodbath between the two communities. So it's a time for the moderates, the pragmatists, to take over and to strike a deal."



World Oil Markets: New Benefits, Old Concerns

Edward R. Fried

ONCE AGAIN, the oil market is exerting a substantial effect on the world economy, this time generally benign. In barely four months—from December 1985 to April 1986—the average price of oil was cut in half, from \$28 to around \$14 a barrel. (Spot prices fell much more, hitting a low near \$10 before recovering somewhat, but the new pricing guarantees now offered by exporters have greatly reduced the significance of spot purchases as a source of supply.) Since the value of oil production accounted for almost 5 percent of the world's total gross national product in 1985, the collapse of oil prices has been a major factor behind recent reductions in inflation and interest rates. If sustained, the drop in oil prices will stimulate world output and employment. At the same time, it amounts, in effect, to a sizable redistribution of income both within and between countries—from energy producers to energy consumers—and, therefore, is causing a wide variety of consequences. Financial markets bask in the afterglow; oil-producing sectors and the industries and banks closely tied to them face painful adjustments.

Before one counts gains or contemplates action to cope with losses, however, several questions need examination. How long will the new world oil situation last? Where, if at all, will it stabilize? Will oil continue to be a recurring wild card in the world's economic future, much as it has been over the past 15 years? Or have the fundamentals become inherently less dangerous, suggesting that oil can now be viewed as but another commodity—unique, to be sure, in size but subject to more or less usual commodity market behavior? And, depending upon one's conclusions about the near- and medium-term future of oil prices, what can be said about the economic and energy security consequences, and what, if anything, need be done now to influence them?

The Road to Collapse

While the extent and suddenness of the fall in oil prices have generally come as a surprise, the underlying trend has been evident for some time. The oil shocks of 1973–74 (OPEC I) and 1979–80 (OPEC II) caused the real price of oil to increase sixfold at its peak, bringing about deep-seated changes in the world energy system. These changes have been substantial enough to warrant viewing the year 1973 as marking a significant divide in the position of oil. Five aspects deserve review as a basis for understanding what happened to make prices fall so rapidly and for speculating about the future.

First, the efficiency of energy use increased sharply. Before 1973 world energy consumption had been rising about as fast as GNP. The barely perceptible falloff in this ratio in the industrial countries was offset by the rise in energy use recorded by the developing countries, as their modernization and industrializa-

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tion accelerated. After 1973 high oil prices reduced energy use in relation to GNP worldwide, a trend that speeded up as investment in energy efficiency rose and capital stock turned over. For the period 1973–85 as a whole, energy consumption increased only 40 percent as rapidly as economic output.

Second, the position of oil in energy consumption sharply eroded. Before 1973 oil was the preferred energy fuel. Relatively cheap and convenient to use, oil successfully challenged coal for fueling new power plants. World economic output became increasingly oil intensive, as oil consumption increased on average by 2 percent a year more than economic growth. After 1973 the position reversed. Oil became the residual fuel in the energy system, displaced in varying degree by coal, natural gas, and nuclear power. At the same time, large efficiency gains were realized in its use.

These changes did not become apparent for some time. Oil consumption did drop sharply immediately after OPEC I, as did economic output, but then it recovered to reach a new peak in 1979. While the increase was well below what pre-1973 trends would have indicated, the fact that it rose, despite higher prices, provided a misleading signal. After 1979, however, when the lagged effects of OPEC I in restraining demand added to the impact of OPEC II, the data tell an impressive story. It became evident that the slowing down in oil use was much more a structural than a cyclical phenomenon. Between 1979 and 1985 oil consumption declined by seven million barrels a day, or 13 percent, in the face of a rise of 15 percent in economic output. The share of oil in the total primary energy supply fell from 55 percent to 45 percent. While the rate of change has been slowing over the past three years, the trend toward greater efficiency in the use of energy and oil is still intact.

Third, non-OPEC production increased sharply, from 16 million barrels a day in 1974 to 28 million barrels a day in 1985. About half of this increase is attributable to major discoveries in Mexico and the North Sea, which predated the oil price jumps. (The Alaska find also predated OPEC I, but because production there was largely offset by declines elsewhere, total U.S. production did not increase.) The remainder of the increase came from later discoveries stimulated by the high OPEC-imposed prices.

Fourth, OPEC found it progressively more difficult to sustain the price increase it had levied in 1979–80. As residual supplier to the world energy system, the Organization of Petroleum Exporting Countries had to reduce its own production between 1979 and 1985 by seven million barrels a day to accommodate the fall in world consumption and by six million barrels a day to accommodate the increase in oil production outside of OPEC. To cope with this pressure, the cartel resorted to a traditional defense. In March 1983 OPEC established explicit country quotas to allocate the production restraint burden among its members. At the same time, it reduced official prices by 15 percent, essentially validating the erosion that had taken place in the market. Later, when world oil consumption failed to recover and non-OPEC production continued to increase, OPEC tightened quotas.

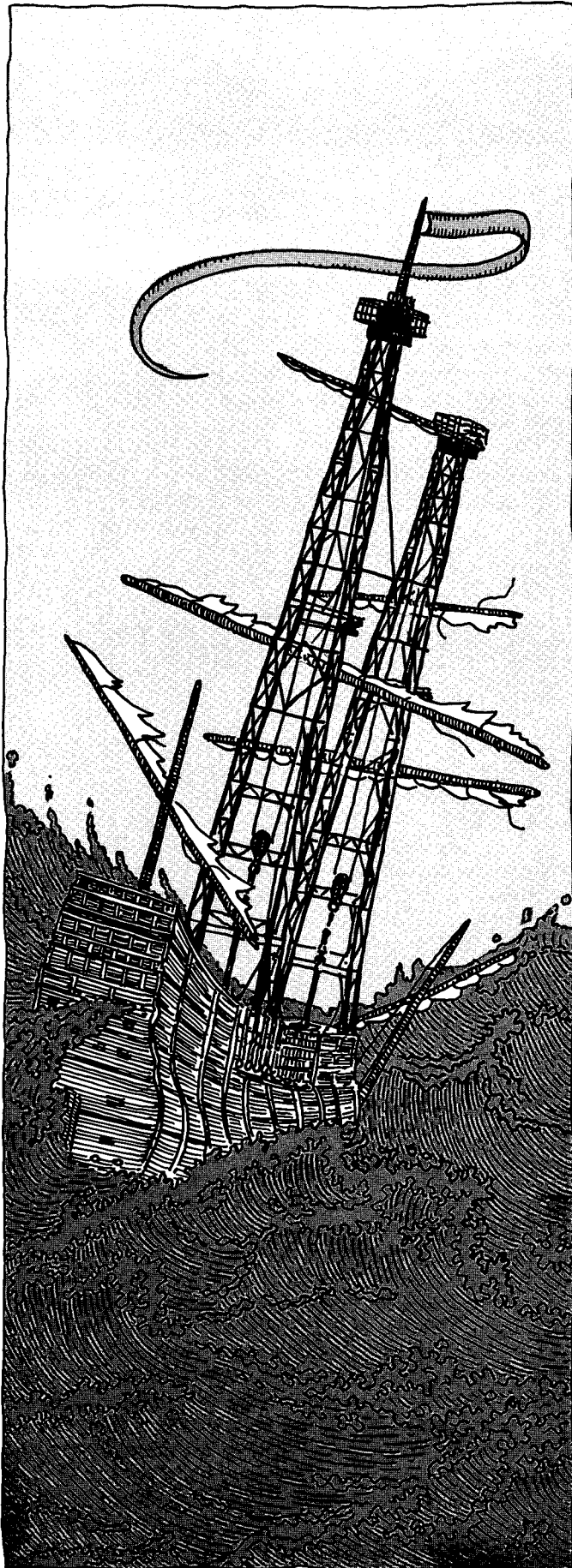
For almost three years, the quotas kept prices fairly stable in dollars, the currency in which oil is denominated. Taking account of the increase in the exchange value of the dollar, the power of a barrel of oil to command imports actually

rose. The cost of this price stability to OPEC, however, was a sharp reduction in export volume. Between 1979 and 1985 OPEC had to cut its production in half, and its share of the world oil supply fell from 60 percent to 35 percent. Oil export revenues declined even more, by 60 percent in constant 1985 dollars, from a peak of \$345 billion in 1980 to \$140 billion in 1985. And the price collapse was yet to come.

Fifth, Saudi Arabia's position of linchpin in the system became untenable. As the lowest-cost and largest oil exporter, Saudi Arabia had consistently, although at times equivocally, sought to exert a moderating role within OPEC on prices. Such a policy is hardly surprising since Saudi Arabia holds one-fourth of world oil reserves and must be concerned about the strength of demand over the longer term. It was strikingly exemplified in 1979–81, when the Saudis maintained production at capacity (nearly ten million barrels a day) in the face of sharply declining world consumption. In fact, the oil price increase of 1979–80 could be sustained only by a cutback of one-third in the production of other OPEC countries; because Saudi Arabia was already producing at capacity, it was powerless to prevent OPEC II from running its course.

On the other hand, when the market softened at the end of 1982, maintenance of OPEC prices depended entirely on a continuing reduction in Saudi production. All other OPEC countries as a group maintained production within a narrow range of 13–14 million barrels a day, discounting prices when necessary to sell that amount. Thus, Saudi Arabia ended up as the sole residual supplier to the world market. This arrangement fell apart in the third quarter of 1985, when Saudi production dropped to some two million barrels a day and the country found itself in the anomalous position of seeing demand for its oil exports disappear. At that point, Saudi Arabia renounced its market-stabilizing role and said it would resort to competitive pricing to regain its market share. The Saudis gradually doubled production to between four million and five million barrels a day, which had been their implicit OPEC quota, and in the process triggered the collapse of prices.

*"How long will the new
world oil situation last?
Where, if at all, will it
stabilize? Will oil continue
to be a recurring wild
card. . . ?"*



Near-Term Prospects

Speculation about where oil prices will settle in the near term depends on conclusions as to Saudi Arabia's motivation in bringing about the present situation. The more extreme explanations for the Saudi behavior seem farfetched. For example, a predatory strategy designed to shut down large blocs of higher-cost production and then to drive up prices rapidly would soon cause countervailing protection in industrial countries, who would see fiscal attractions as well as energy security reasons. Or if the Saudis' main objective were to bring financial pressure on Iran to end its war with Iraq, the price instrument would entail grossly outsized costs in relation to its effect.

A plausible explanation, consistent with the factors underlying the price collapse, is much more straightforward: Saudi Arabia's objective is to reestablish stable, OPEC-administered prices on a stronger foundation and to put pressure on other oil-exporting countries inside and outside OPEC to cooperate in bringing this about. A reinvigorated administered system would require a price low enough to assure a steady growth in world oil consumption and to exercise constraint on non-OPEC production, some of which is high-cost, yet high enough to realize sizable economic rents and to avoid political upheavals in oil-exporting countries. Allowing for the perils of oil forecasting, it seems clear that such a price would have to be substantially below the 1985 level of \$28. Otherwise, little change could be expected from the market trends that prevailed then and that proved to be inherently destabilizing for OPEC.

A rejuvenated system would also require effective export production restraints to support the agreed-upon price. The Saudis therefore would want assurance that other OPEC producers would share in the residual-supplier role and that non-OPEC oil-exporting developing countries would cooperate in restraining production when necessary. Implicit cooperation from Norway, the Soviet Union, and the United Kingdom would be helpful but is much more problematical, although Norway sometimes sounds as though it would be prepared to move in that direction.

Current market forecasts suggest that at present prices, world oil consumption in the next 12 months might increase by as much as 2 percent and that for the first time in a decade non-OPEC production will, at best, be flat. If so, an initially viable agreement could be reached by setting the price in the \$15–\$20 range. Such a price could be supported by reinstating the currently suspended OPEC quotas, perhaps reduced modestly at the start for market effect. The Saudis and their close oil allies, Kuwait and the United Arab Emirates, likely would prefer to set the price at \$15 and work upward slowly as market developments justify. Other OPEC members in varying degree would insist on \$20 or higher. A compromise at \$18 is a reasonable possibility. If a different price is set, it is more likely to be higher rather than lower.

Nothing in the recent history of OPEC ineffectiveness suggests that an agreement could be reached easily or soon. However, both the atmosphere and the fundamentals are substantially changed. Saudi threats now have credibility, the more because they are producing at only 50 percent of capacity. Only the Saudis have gained export revenues—at least from their low point in the third quarter of 1985—from the price collapse. All other oil-exporting countries, espe-

cially those producing at or near capacity, have lost heavily. An agreement would mean gains for all of them. The fact that some non-OPEC developing-country exporters seem to be prepared to negotiate on the basis of specific OPEC proposals is evidence of the emerging change in attitudes. Sooner or later, these factors will lead to an agreement, which is likely to be in operation this year.

Medium-Term Prospects

A useful start in examining medium-term prospects is to assume that OPEC manages to stabilize the price at \$18 a barrel and keep it there until 1990, adjusted only for inflation. That would mean a drop of one-third from 1985. In real terms, an \$18 price would wipe out the increases of 1979–81 plus part of the first oil shock. Still, the real price of oil would be about three times the 1972 level.

Recent forecasts suggest that an \$18 price would substantially alter the oil market outlook, specifically the residual demand for OPEC oil. It would increase oil use directly, reduce the rate of substitution of other fuels for oil, and slow down efficiency gains in oil consumption. These trends were already noticeable in the past few years; a lower price would accelerate them. The effects would be modest at first but would increase with accumulating force. In a world economy growing at 3 percent a year, oil consumption might increase annually at an average of 2 percent, or by five million barrels a day by 1990.

Initial effects on the supply of non-OPEC oil would be more modest. Even in the United States, Canada, and the North Sea, operating costs on average are comparatively low — probably around \$5 a barrel. They would still be amply covered by an \$18 price. Furthermore, part of the revenue losses from the reduction in prices from \$28 in 1985 have been absorbed by governments in the form of reduced oil tax receipts. Nonetheless, despite lower taxes and substantial cuts in cost of inputs, drilling is being severely curtailed. More than 50 percent of the operating rigs have been shut down so far this year, and many companies have announced large cutbacks in exploration programs. The impact on production, however, would not be felt until later on. A reasonable speculation is that by 1990 the supply of non-OPEC oil would be reduced by some one million barrels a day, with a substantial share of the loss coming from the shutdown of high-cost production in the United States.

On these projections, the demand for OPEC oil (including natural gas liquids) would increase from 17 million barrels a day in 1985 to perhaps 22 million to 24 million barrels a day in 1990. That would be enough to relieve most of the pressure within the cartel while still leaving Saudi Arabia and its Gulf allies in the driver's seat. Iran and Iraq each could increase production by at least half when their war finally comes to an end; those countries under severe financial pressure could produce near capacity; the others could divide modest increases in exports among themselves. Surplus capacity would still be large—some six million to eight million barrels a day—most of it concentrated in the Persian Gulf. If events follow these projections, Saudi Arabia, while still proceeding cautiously, likely would permit moderate increases in real prices toward the end of the decade.

Beyond 1990, and again assuming that world economic growth averages 3 percent a year, the market would con-

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tinue to tighten, the extent depending not only on the price path OPEC adopts and its effect in restraining oil consumption but also on how rapidly exploration expenditures in non-OPEC countries recover. In view of the long lead time between drilling and production — averaging about five years — companies must base their oil investment decisions on price expectations over the longer term rather than on the present price. Resuscitation of a viable OPEC system presumably would diminish uncertainty and improve price expectations, thereby leading to an early turnaround in exploration expenditures. Present turmoil in the oil industry, however, is very severe. Conceivably, therefore, the supply of non-OPEC oil in the early 1990s might be down by two million or three million barrels a day from what it would have been on the basis of price expectations prevailing in 1985. All in all, a plausible guess is that by the mid-1990s the real price of oil will have recovered to the 1985 level and the demand for OPEC oil will have increased to between 26 million and 28 million barrels a day. This outcome, it hardly needs specifying, assumes a surprise-free international environment, that is, the absence of a substantial interruption of supply from the Middle East.

Economic Implications

We have already witnessed the kinds of economic effects to be expected from a sharp drop in oil prices. The declines in consumer prices and interest rates are the most dramatic examples. If the price of oil were to become stabilized at \$18 for the next few years, these gains would be consolidated and to some degree strengthened.

Compared with 1985, an \$18 oil price would transfer \$75 billion dollars a year from oil-exporting to oil-importing countries. Some \$60 billion would accrue to industrial countries and \$15 billion to oil-importing developing countries. These terms of trade, or income, gains would equal almost three-fourths of one percent of their GNP. In the aggregate, these income transfers from the price collapse would amount to about one-third of those that followed the price shock from OPEC II, in the opposite direction.

Inflation would be significantly reduced. The direct impact on consumer prices would be on the order of one and one-half percent. Prices of competitive fuels — notably coal and natural gas — would also decline, but by lesser amounts. So would cost-of-living adjustments in wage settlements. After all these changes work their way through the system, the total reduction in inflation stemming from the oil price collapse might total 2–3 percent spread over two years.

The extent and duration of the fall in interest rates depends, of course, on monetary policy in the industrial countries. Certainly the dampening of inflation would provide monetary authorities with more leeway to permit rates to decline.

In general the collapse in oil prices should mean higher world economic growth. Just as the earlier upward price shocks were likened to a giant excise tax imposed from without, so should a price collapse be seen as a tax cut. However, there are offsetting effects. As the Organization for Economic Cooperation and Development (OECD) describes it, “the central demand side question is whether those who lose from the income transfer adjust their income more or less rapidly than those who gain.” In present

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circumstances, and adjusting for differences in the size of the shocks, it is likely that the demand-stimulating effects of the fall in oil prices will not be as favorable in 1986–87 as the demand-depressing effects of OPEC II were unfavorable in 1980–81.

A sharp reduction in sales to oil-exporting countries as their foreign exchange earnings decline is the principal demand-depressing offset to the stimulus of higher incomes in the oil-importing countries. High-debt oil-exporting countries, for example, Mexico, Nigeria, and Indonesia, have limited capacity to borrow new money abroad to make up for the large shortfall in their export receipts. Low-debt countries like Iran, Iraq, and Libya would be reluctant for political as well as economic reasons to borrow heavily to maintain the existing volumes of their imports, and, in any event, would have difficulty doing so. Even the capital surplus countries, namely Saudi Arabia and Kuwait, are unlikely to draw heavily on foreign exchange reserves to maintain imports. In all, the decline in sales to these countries in 1986 is estimated to offset 60 percent of the income gains the importing countries receive from lower import costs.

Another possible adverse effect on aggregate demand could arise from the way the sizable redistribution of income taking place within the oil-producing industrial countries works itself out. The United States is the major case in point. A drop of \$10 a barrel in the price of oil amounts to a transfer of \$35 billion from domestic oil producers to oil consumers (leaving aside changes in government tax receipts from both groups). Employment is down in the depressed oil sector and investment is being cut heavily, perhaps by \$15 billion in 1986. Employment and investment in allied industries are also being hurt. Against these losses in aggregate demand, consumers generally have more to spend and the industries that benefit from this increase will eventually increase investment. The net effect on aggregate demand is difficult to quantify, but in view of the steep, rapid cutback in the oil sector, it could well be initially negative.

All in all, an oil price of \$18 could increase world economic output at the end of two years by 1 percent, or \$100 billion, above what it otherwise would be. By that time, most adjustments to a lower oil price would have been made and trend growth restored. Country positions would vary widely. Output gains would be proportionately higher in Japan and the Western European oil-importing countries

than in the United States. Compared with the United States, oil imports in these countries are larger in relation to GNP, and oil prices, which are denominated in dollars, have fallen further because of the appreciation of their currencies. As net oil exporters, the United Kingdom, Norway, and Canada will be losers along with the oil-exporting developing countries. The Soviet Union stands to lose about one-fourth of its hard currency earnings.

Apart from the effects on output, the shift in the terms of trade would constitute a continuing transfer of economic rents from oil-exporting to oil-importing countries, amounting to some \$75 billion in 1986 and adjusted thereafter by changes in the price of oil and the volume of oil trade. Furthermore, the decline in inflation and interest rates would provide a stronger foundation and additional policy leeway for maintaining world output at more nearly satisfactory levels.

Mention also needs to be made of the net effect of the lower oil price on the debt problem, since the high-debt developing countries include both oil exporters and importers. Compared with 1985, an oil price of \$18 in the first instance would cost high-debt oil-exporting countries \$25 billion and save oil-importing countries \$15 billion. Indirect benefits would redress this net negative position. For example, if the lower price of oil eventually increased OECD output by 1 percent and reduced interest rates by 2 percent, the combined current account of all debtor countries could eventually benefit by an estimated \$25 billion (through increased non-oil exports to OECD countries and reduced interest costs on foreign debt). Taking both direct and indirect effects into account, the foreign exchange losses of the high-debt oil exporters could amount to \$20 billion while the gains to the oil importers would be some \$35 billion.

This apparent net improvement in creditworthiness of debtor countries as a group could be misleading. Intensification of pressure on several oil exporters — of which Mexico is by far the largest and recurring example — could threaten new debt crises that might place the international financial system at risk. Averting such crises will require coordinated, international action on a continuing basis, along the lines envisaged by the Baker initiative. Success is by no means assured but at least the prospects should be somewhat brighter in the more buoyant world economic climate that lower oil prices foster.

Energy Security and Policy Implications

If the real price of oil recovers over the next few years along the price path projected earlier, most of the economic effects of the price collapse would be reversed. Such a gradual pace of change, however, should pose few problems. On average, the economic impact would amount to less than one-tenth of one percent a year of the GNP of oil-importing countries.

That still leaves the oil security problem unaddressed. Lower oil prices will eventually lead to higher oil consumption and depress non-OPEC oil production. Dependence on OPEC oil would then increase and surplus OPEC production capacity diminish. There is much uncertainty about the speed of change but not about the direction. These developments will increase vulnerability to a sudden interruption of oil supplies from the Middle East — that is, to another oil shock.

"This apparent net improvement in creditworthiness of debtor countries as a group could be misleading. Intensification of pressure on several oil exporters — of which Mexico is by far the largest and recurring example — could threaten new debt crises that might place the international financial system at risk."

In assessing possible costs, it would be wrong to assume that a future oil supply interruption will look like a replay of the past. A great deal has been learned by importing and exporting countries alike. Industrial countries are now more keenly aware of the futility of seeking preferred access to oil supply and of the danger of a competitive scramble for stocks. They are better prepared to coordinate action and use stocks in an emergency. Arab countries have a more realistic view of the limitations of using oil as a political instrument, especially after they failed even in the confused circumstances of 1973 to deprive the United States of access to oil. OPEC countries generally, and Saudi Arabia in particular, are sensitive to the adverse longer-term market consequences of a sharp run-up in price.

Nonetheless, the likelihood exists that in the 1990s surplus OPEC production capacity will be greatly reduced — perhaps to as little as three million to five million barrels a day, virtually all of it in the Persian Gulf region. At the same time, threats to the oil supply chain arising out of trouble in the Middle East will remain a matter of serious concern. Political turmoil, revolution, or a new outbreak of military hostilities could bring about the partial or complete stoppage of production in Saudi Arabia, or effectively interfere with shipping in the Persian Gulf, or cause damage to production or pipeline facilities. The resulting shortfall in Persian Gulf exports could not be made up by increased production elsewhere. If no offsetting action were taken — the main possibility being a coordinated drawdown of stocks under the emergency program of the International Energy Agency (IEA) — the market would be brought into balance by a sharp increase in oil prices. Again, the damage to the world economy could be substantial.

That raises the question of whether the United States can take cost-effective actions now to reduce this energy security risk, recognizing the large uncertainties inherent in projections of what oil markets will look like five or ten years from now. Some of the possibilities would use the tax mechanism to enhance energy security. These are examined without reference to their effect on revenues. Another approach would increase the volume of oil stocks available for use in an emergency and strengthen international emergency procedures.

Adoption of an oil import tax would reduce U.S. oil consumption and protect high-cost production that otherwise would be shut down. The extent to which such a tax would

affect the world oil market five or ten years from now is difficult to quantify, but the impact is likely to be small. For example, the U.S. Energy Information Administration recently estimated that if the oil price stabilized at \$20 a barrel, a \$5-a-barrel tax on U.S. imports of crude oil and products would reduce the demand for OPEC oil by 600,000 barrels a day in 1990. At the same time, by increasing the domestic price of oil by that amount, it would deprive the United States of almost half its economic gains from the lower world oil price. However, if Saudi Arabia, contrary to expectations, should pursue a predatory policy aimed at temporarily keeping the price of oil at \$10–\$15 a barrel, a variable import levy triggered at prices below \$15 might look more cost-effective as a means of avoiding an even more severe dislocation of the domestic oil sector, which subsequently would be costly to repair.

An excise tax on gasoline would reduce oil consumption. Because such a tax would not help U.S. oil production, its contribution to energy security would be smaller than that of a tax on oil imports. Energy Information Administration estimates indicate that an additional tax of 12 cents a gallon on gasoline (equivalent to a \$5-a-barrel tax on oil) would reduce U.S. oil consumption in 1990 by 300,000 barrels a day below what it otherwise would be. The same amount of tax imposed on all uses of oil would increase these savings to 500,000 barrels a day. But, since excise taxes would increase the domestic price of oil by about one-third as much as an equivalent tax on oil imports, it would leave intact more of the economic gains from the reduction in world oil prices than would an oil import tax.

Resumption of purchases of crude oil for the Strategic Petroleum Reserve (SPR) would provide more breathing room to contain the effects of a Middle East supply interruption. The administration now plans to stop purchases for budgetary reasons, with the SPR at 500 million barrels. The objective had been 750 million barrels. U.S. emergency stocks must be used in conjunction with emergency stocks of the other IEA countries; otherwise almost two-thirds of their effectiveness in containing price increases would be lost. Under present programs, IEA countries together should have effective emergency stocks equal to about 50 days of their total projected imports. That would be sufficient, for example, to offset in full a sudden loss of six million barrels a day of Middle East oil for about six months. Or it could last for a longer period if the safeguard strategy called for a partial supply offset and some increase in price. Since lower oil prices heighten the risk to energy security, the United States could seek agreement in the IEA to raise emergency stocks by 50 percent over the next three years or so to increase the potential to avoid damage. For the United States, this would mean restoration of the SPR objective to 750 million barrels; comparable action would have to be taken in other IEA countries. Financing the additional reserves could be facilitated through agreement on the imposition of a special oil import tax of 50 cents a barrel for three years by all IEA importing countries.

In sum, the sharp drop in oil prices is a positive but not a risk-free economic development. While the assessment of risk is subject to a great deal of uncertainty, the damage, should the worst materialize, could be severe. Action to increase emergency oil stocks and strengthen the international machinery for cooperating in oil emergencies looks like the most promising course to take.

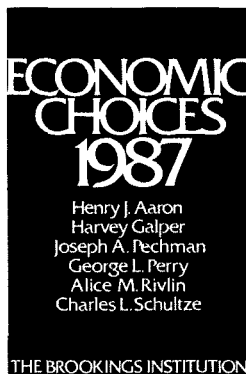
*“... the sharp drop in oil
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Economic Choices

Economic Choices 1987

By Henry J. Aaron, Harvey Galper,
Joseph A. Pechman, George L. Perry,
Alice M. Rivlin, and Charles L.
Schultze

\$8.95 paper; \$22.95 cloth.



WARNING that the federal deficit will not just melt away and rejecting the Gramm-Rudman-Hollings budget balancing law as a "doomsday machine," six prominent Brookings economists call instead for a tax increase and further spending cuts to bring the deficit down to an acceptable level.

In *Economic Choices 1987* the six authors — Alice M. Rivlin, director of the Brookings Economic Studies program, and senior fellows Henry J. Aaron, Harvey Galper, Joseph A. Pechman, George L. Perry, and Charles L. Schultze—agree that the deficit reduction targets of the Gramm-Rudman-Hollings Act are a reasonable guide to budget policy at least for the next three years. Under the economic conditions that are most likely to prevail, the targets should be attainable without inviting either recession or excessively slow growth. A falling dollar is likely to strengthen demand for U.S. products during the next several years. Moreover, appropriate monetary policy by the Federal Reserve could offset any remaining short-term weakness caused by spending cuts or tax increases.

But while the deficit reduction targets of Gramm-Rudman-Hollings are reasonable, the authors point out that holding to those targets in a recession would be very damaging to the economy. Moreover, reducing the deficit through the automatic budget-cutting formula of the act would seriously damage military readiness and the civilian operations of the government.

Economic Choices 1987 analyzes three alternative budget strategies: specific congressional action to cut the budget along the broad priorities of Gramm-Rudman-Hollings without the automatic formula, the president's proposals, and the preferred alternative of the Brookings authors. Each option reduces the deficit to about \$72 billion in fiscal 1989 but does it in different ways. The authors believe that while "the president has proposed some sensible cuts and reforms in various programs, his continued commitment to defense growth and opposition to a tax increase force him to subject social programs to cuts that are both excessive and politically unacceptable. As a share of gross national product, spending for domestic programs other than social security would fall well below the levels of the 1960s."

The Gramm-Rudman-Hollings package is equally untenable, but for different reasons. The Brookings economists believe that the defense cut under this approach would be too deep and would weaken the readiness of the armed forces. The domestic cuts would also produce distortions and inequities because they are concentrated in a small segment of the budget. According to the authors, "by 1989, total outlays of the unprotected civilian programs would be cut 30 percent below the 1981 levels in real terms." Congress would not accept cuts this big in such programs as law enforcement, tax collection, and air traffic control. Therefore, even more drastic cuts would be needed in other civilian programs, which is politically unrealistic.

The alternative proposed by the Brookings scholars offers a tax increase to help alleviate the unacceptable consequences of the other two options, endorses some of the president's proposed spending cuts, and restores some funding for programs already cut too deeply. Under this proposal, "real defense spending would be the same in fiscal 1989 as in 1986 and would support a strong defense posture. Real outlays of unprotected nondefense programs would decline 11 percent between 1986 and 1989, but this cut need not be seriously harmful provided it is confined to low-priority programs."

The Brookings study calls for a \$50 billion increase in excise taxes and individual and corporation income taxes in fiscal 1989 to reduce the deficit to the Gramm-Rudman-Hollings targets. The taxes would be raised either by broad-

ening the base of taxation or by smaller cuts in tax rates than are pending in Congress. The tax base could be broadened by taxing some of the employee fringe benefits now excluded from tax, taxing a higher proportion of social security benefits, or limiting deductions for state and local taxes on federal tax returns.

Among excise taxes, oil and gas taxes could produce the most revenue. A tax of \$5 a barrel on imported oil would raise about \$7.5 billion in fiscal 1989; the same tax on both domestic and imported oil would generate \$22 billion. Doubling the levy on cigarettes would restore these taxes to the same real levels they were at in 1958, while doubling liquor taxes would return them to 1973 levels. These increases would produce added revenue of almost \$10 billion in 1989. Increased taxes on cigarettes and alcohol would also ensure that heavy consumers of these products would pay a greater proportion of the costs they impose on society for health care. The authors believe that "reasonable increases in excise taxes could add from \$15 billion to \$30 billion to federal revenues in 1989."

Making the News in the Senate

ALTHOUGH each is equal when the roll is called in the 100-member Senate, senators are undeniably unequal when it comes to attention they receive from the national media. According to a new study by Stephen Hess, about 20 senators monopolize national news coverage. Ten of those draw half of the total coverage.

In *The Ultimate Insiders: U.S. Senators in the National Media*, Hess finds that the national media coverage of most senators is largely determined by their place in the Senate hierarchy. "Today those who do the work get most of the publicity," writes Hess, a senior fellow in the Brookings Governmental Studies program. His study demonstrates that the national press corps is not lured to the young, attractive junior members as some observers have claimed. "Neither good looks nor clever views can compete with the aphrodisia of a leadership position. So long as the Senate lives by seniority, Senator Blowdried will never be able to compete with Senator Mandarin for sustained attention on the network evening news or in large-circulation newspapers," he says.

Hess concludes that rather than being a destabilizing and decentralizing force, scattering attention among a wide range of junior legislators, the national news media focus on those senators who seem to wield institutional power. Since 1953 the national news outlets have increasingly directed their attention to the definable leaders at the expense of the followers, mavericks, and others.

Hess finds that Senate reporters for national outlets think about their beat in terms of power. They gravitate toward those legislators who are the "ultimate insiders" — the ones who call the committee meetings or direct the floor action, or who would do so if their party were in the majority. The correlation between seniority, leadership, and press attention means that the senators most sought after by the national reporters are, on average, approaching 60 years of age and are in their third term. The exceptions are senators who seek the presidency, in which case the news media are interested regardless of age or leadership position. "The best way for a senator to be noticed by the national media is to run for president, or, if it is credible, to hint broadly of his or her availability for the job," Hess writes.

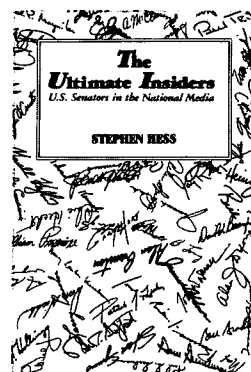
Hess shows that committee assignments contribute to senators' media exposure. "The right committees do not guarantee success," he writes, "but being on the wrong committee is the high road to going nowhere in the news media." The top "media committees," according to his system of ranking, are Foreign Relations, Judiciary, Budget, and Governmental Affairs.

Another way to get media attention is to become "a temporary leader" on a

The Ultimate Insiders: U.S. Senators in the National Media

By Stephen Hess

\$8.95 paper; \$22.95 cloth.



particular issue. But when the issue is resolved, Hess notes, these senators step back into rank. A more permanent guarantee of media success is to become an "expert" because the national media need specialists, Hess says. Sometimes a legislator can take charge of an issue—from the journalists' perspective—even if the lawmaker is not on the appropriate committee or has not been in office long or both. In most cases, however, the press continues to assign to a committee's members the right to be the experts in that field.

Hess finds that the judgment of television and print reporters about whom to cover is not very different—television and newspapers tend to focus on the same 20 senators and ignore the same 80. "Those on the lower end of the Senate's national media scale are an odd admixture in terms of why they stay out of the limelight. The underachievers include the too old, too new, too scared, too provincial, too stupid, and too uninterested. Some members fit in more than one category," Hess observes.

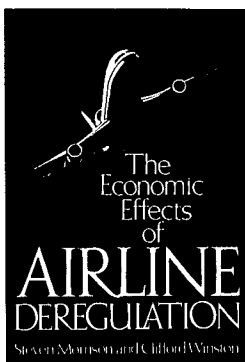
In comparing his results with past media rankings of senators, Hess also finds that most senators—between 80 and 90—receive so little attention from the three television networks and other elements of the so-called prestige press that the national news media are irrelevant in affecting their elections or promoting their policies. This is the reality now, and it has been the reality for at least three decades.

This is the third volume in the Newswork series by Hess. It follows *The Washington Reporters* (1981) and *The Government/Press Connection* (1984).

The Friendly Skies of Deregulation

The Economic Effects of Airline Deregulation

By Steven Morrison
and Clifford Winston
\$7.95 paper.



AIRLINE DEREGULATION has saved travelers and carriers significant amounts of money without causing any substantial losses to specific groups, according to Steven Morrison and Clifford Winston in their new study, *The Economic Effects of Airline Deregulation*.

Morrison, an associate professor of economics at Northwestern University, and Winston, a research associate in the Brookings Economic Studies program, analyze the impact of the Airline Deregulation Act of 1978 on the welfare of travelers, carriers, and labor and on the quality of service to small communities and particular geographic regions. They find that lower fares and better service under deregulation have saved travelers \$6 billion and improved overall airlines earnings by \$2.5 billion annually (in 1977 dollars).

The Airline Deregulation Act of 1978 was the first step toward complete deregulation of the industry after 40 years in which the government set fares and decided which carriers served which markets. The authors credit deregulation with accelerating the development of the hub-and-spoke operation, which feeds travelers into a major airport, or hub, from which they take connecting flights to their destinations. Hub operations have enabled carriers to use labor and equipment more efficiently and to provide more convenient service. Business travelers especially have benefited from the improved service, particularly from increased flight frequency in low-density markets.

Morrison and Winston also find that deregulation has resulted in:

- A reduction of administrative costs to the federal government for salaries and office space incurred under regulation.
- A decline in the cost of federally subsidized air services.
- No reduction of wages in the airline industry during 1977–83. But the recent institution of two-tier wage structures, under which new hires are paid substantially less than employees hired before negotiation of the contract, suggests deregulation may have adverse effects on labor in the long run.
- No adverse effects on industry employment.

—No gains or losses concentrated in particular regions or on particular types of routes.

—No loss of service to small communities, but rather increased benefits to travelers originating at small communities.

The authors also evaluate deregulation in terms of how close it has moved the airline industry to the socially optimal configuration of fares and services, that is, the point at which fares and frequency of service are at optimal levels for travelers but still provide a normal rate of return to carriers. They estimate that deregulation could further increase annual benefits by roughly 30 percent, or \$2.5 billion (in 1977 dollars), with the largest gains coming from more frequent departures, particularly in low-density markets.

Because deregulated markets are not perfectly competitive, the degree of competition needed to realize these optimal levels will probably not be achieved, Morrison and Winston write. But significant benefits are still possible. Carriers have been aligning their fleets with their deregulated route structures and markets, adopting fuel-efficient, medium-sized jets and aircraft designed to be operated by two rather than three pilots. "Once carriers have completely aligned their fleets with their deregulated route structures and markets, benefits will be even greater," the authors write.

The new industry capital structure will lead to more carrier efficiency gains under deregulation and to a reduction in industry costs, owing to more efficient use of labor. Industry takeovers will not harm travelers' welfare, the authors predict, because actual and potential competition in high-density markets should remain sufficient to maintain the level of benefits achieved under deregulation, and the increased importance of a well-developed commuter network in the more concentrated competitive environment may actually bring greater benefits to travelers on low-density routes.

"The evolution of the deregulatory capital and industrial structure of U.S. airlines is thus likely to enhance the welfare improvements already generated under deregulation," the authors write. "In light of all these findings, policymakers would do well to maintain current deregulatory policies and vigorously pursue new competitive policies in air transportation," they conclude.

An Alternative Defense Plan

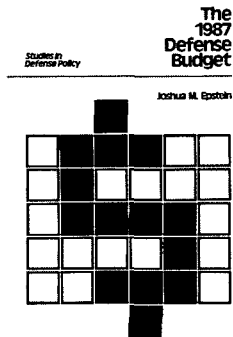
IN A NEW STUDY, *The 1987 Defense Budget*, Brookings scholar Joshua M. Epstein proposes a military plan that would reduce defense budget authority by \$171.2 billion over four years and save \$117.1 billion in outlays during the same period, while providing for a strong national defense. Epstein, a research associate in the Brookings Foreign Policy Studies program, argues that the Reagan administration's defense plan includes six features that require careful examination:

- An exaggerated assessment of Soviet military power, one based largely on static and oversimplified measures of military strength.
- An underassessment of U.S. and allied military efforts, which, combined, have outstripped those of the Soviets and their allies for the last two decades.
- The adoption of strategies that, even if feasible, are inefficient in accomplishing basic military tasks and that elevate needlessly the risk of escalation.
- Excessive growth rates in programs of doubtful urgency.
- Wasteful redundancies of weapons systems.
- Payment of uncompetitive prices.

Epstein proposes an alternative budget based on careful assessments of the main missions facing U.S. military forces: nuclear deterrence and the conventional defense of Western Europe, the Persian Gulf, South Korea, and the

The 1987 Defense Budget

By Joshua M. Epstein
\$7.95 paper.



sea and air lanes to these potential theaters of war. He emphasizes that the defense of Western Europe is and should remain the centerpiece of American national security policy. Under likely wartime scenarios, Epstein says, the conventional military balance in Central Europe is considerably more favorable to NATO than is generally assumed. The Soviets may have more divisions, he adds, but the number of divisions is less significant than the quality of those divisions. NATO outspends the Warsaw Pact on defense and enjoys technological and defensive advantages. In addition, Western troops are better trained. Epstein concludes that "NATO possesses the material wherewithal to stalemate the Warsaw Pact." He calls for stressing the front lines of NATO's defense rather than continuing the administration's "headlong plunge into promising, but unproven, longer-range technologies" that would allow NATO forces to retaliate deep inside Eastern Europe. Accordingly, Epstein recommends shifting away from the F-15E aircraft associated with the administration's deep attack strategy toward the less expensive, multipurpose F-16, supplemented by upgraded F-4s and measures to enhance defensive effectiveness. The shift would net four-year savings of about \$19 billion in budget authority.

Further, he argues that the 15-carrier fleet advocated by the Navy is inadequate for offensive purposes but wasteful for defensive purposes. A 12-carrier fleet is sufficient to secure the sea lanes in conjunction with other, equally effective tactics. At the same time, submarine offensives against Soviet ballistic missile submarines — a second component of the maritime strategy — are extremely expensive, potentially escalatory, and unnecessary for defense of the sea lanes. Appropriate cutbacks would result in four-year budget authority savings of \$37.9 billion.

Epstein's analyses of conventional force requirements account for critical operational factors that he believes have been particularly neglected in assessments of the Persian Gulf. When compared with the forces the Soviets could actually sustain in the region, the United States would only need five tactical air wings, five ground divisions, and special forces. Two of the Army light divisions available for such duty should be reorganized for use in Europe. At the same time, sealift deserves priority over airlift; while expanding the acquisition of fast sealift ships, Epstein would cancel the C-17 airlift aircraft, for net budget authority savings of \$6.7 billion through fiscal 1990.

Other conventional force recommendations include reducing the growth rate of the M1 tank program and canceling the Bradley Fighting Vehicle and AMRAAM missile for four-year savings of \$8.4 billion in budget authority. Canceling production money and reducing development funding for the Stealth bomber while funding other stealth technologies, imposing a cap of 50 on deployed MX missiles, reducing the rate at which MX test missiles are procured, and freezing funding at fiscal 1985 levels for the Strategic Defense Initiative and Midgetman would account for roughly \$56 billion in budget authority through fiscal 1990. Epstein also says that an additional \$13.3 billion could be saved by eliminating excessive defense contractor profits.

Political Conflicts Stymie Energy Policy

The Politics of Energy Conservation

By Pietro S. Nivola
\$12.95 paper; \$32.95 cloth.

EVEN THOUGH a substantial tax on gasoline consumption might be the best way to achieve conservation, the U.S. Congress will find it difficult to impose such a levy, Pietro S. Nivola writes in *The Politics of Energy Conservation*. Nivola examines the dispute over the gasoline tax that has raged on and off since the mid-1970s when it was proposed as a conservation measure and concludes that "gasoline tax initiatives of all shapes and sizes tend to suffocate in the acrimonious congressional quarrels they always provoke." Although Congress ap-

proved a tax hike of a nickel a gallon in 1982, enactment of that tax "was something of an accident," Nivola writes, "one with rather long odds against being repeated at any time soon."

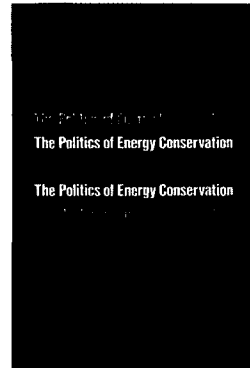
Nivola, an associate professor of political science at the University of Vermont and a former guest scholar at Brookings, argues that conflicting views about the role of government are at the core of the dispute over the gasoline tax. Not only is there little or no active constituency for such a policy, but the option is difficult to enact because of attacks from opposite ends of the partisan spectrum. Members of the political left, whose perennial grievance is that upper-income groups are not carrying their fair share in taxes, feel that another nonprogressive levy, especially on consumption of a vital commodity, adds "insult to injury." At the same time, conservatives worry that if new, potentially copious sources of federal revenue are discovered, the government will have an excuse to increase spending. In addition, they contend that a stiff federal gasoline tax preempts a major revenue source of the states.

The ideological conflicts that plague enactment of a gasoline tax pervade the pricing decisions of all energy sectors, according to Nivola. He traces congressional decisions on the pricing policies of petroleum, natural gas, electric rates, and gasoline in the late 1970s and early 1980s and shows that the conflicts among federal policy-makers stalled action on the most effective means of achieving conservation — price disincentives. If the energy pricing policies charted during those years had given freer rein to market forces, much of the progress toward a sound national energy posture based on conservation would have been achieved by now, he says.

He analyzes how special interest groups, public opinion, localism, and governmental leadership affected the decision-making process, and finds that these influences fail to account completely for the inability of policy-makers to make rational pricing decisions. Partisan and ideological politics were often more important determinants of policy decisions in Congress. "Far from becoming consensual ruminations about practical energy-savings methods, essential moves, such as deregulation of oil and gas, were transformed into ideologically charged controversies, frequently pitting the great majority of Democrats against a great majority of Republicans," Nivola says.

Although both Republicans and Democrats have argued for various market solutions to energy problems, a deadlock develops, Nivola writes, because both sides wrangle strenuously about "the right" approach with "each side convinced that it knows more about what government ought to do to make markets function beneficently." The Republican party's desire to build national wealth with emphasis on the supply side, while paying less attention to the distribution of wealth, clashes with the Democrats' vision of equitable pricing policy. "Whatever else the regulation of energy prices was supposed to accomplish," Nivola argues, "many Democrats saw it as 'the little guy's' last line of defense against rapacious oil companies and as a form of social insurance compensating for the regressive effects of rising fuel costs."

A critical examination of energy pricing and conservation is still essential, Nivola argues. World petroleum prices have retreated, the OPEC cartel appears to have crumbled, and past shortages are a distant memory, making now an appropriate time to reflect on the policy mistakes of the past and to address unfinished items on the energy policy agenda. Reemergence of what has been called a glut psychology may leave the nation unprepared for the next energy emergency. The federal government's most noteworthy accomplishment in the field of conservation — deregulation of petroleum prices — has not sufficed to secure long-range efficiency in the use of energy, Nivola concludes. Political divisions still complicate the modern battles over energy pricing, resulting in a policy that fails to utilize the advantages of pricing disincentives.

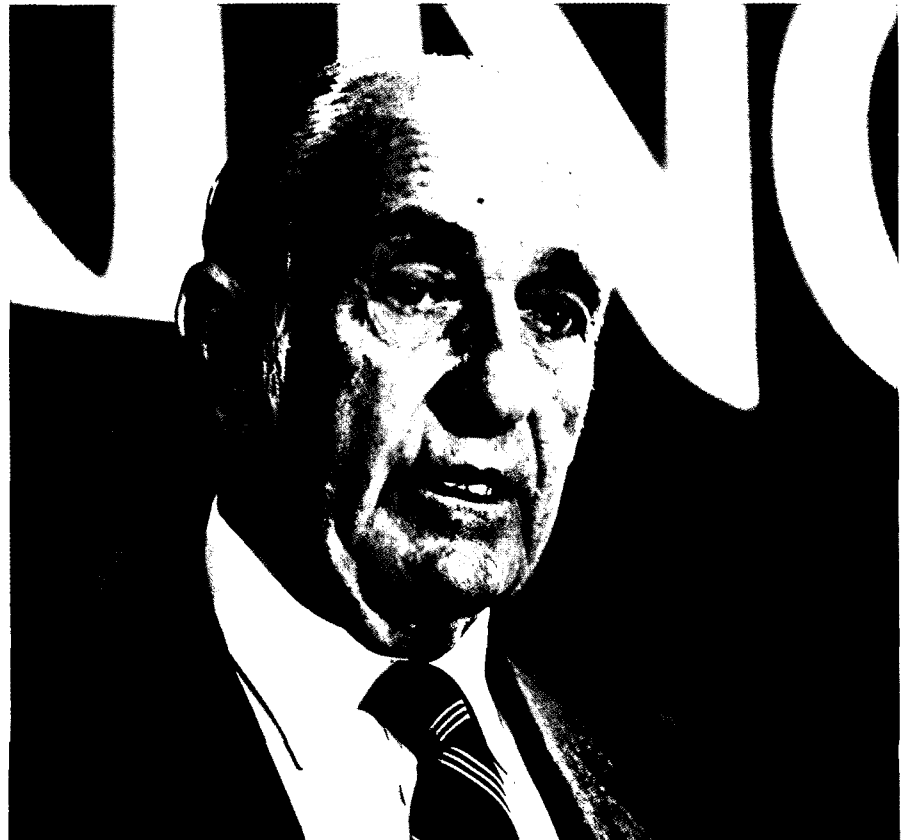


Forum on Defense Procurement

DAVID PACKARD, chairman of the President's Blue Ribbon Commission on Defense Management, outlined his panel's procurement reform recommendations at a recent Brookings conference. During the day-long event, members of Congress, the under secretary of defense for research, and chief executive officers from the defense industry participated on panels that discussed options for reform, industry perspectives on defense management, and the outlook for the future. The session was one of a series of National Issue Forums conducted by the Center for Public Policy Education at Brookings.



Sanford N. McDonnell, chairman, chief executive officer, and director of the McDonnell Douglas Corporation.



Right: David Packard, chairman of the President's Blue Ribbon Commission on Defense Management.

The Federal Deficit

THE AUTHORS of Brookings' new book, *Economic Choices 1987*, presented their conclusions at a recent press conference. The authors examined the outlook for the economy and the budget and offered a plan for cutting the deficit through a combination of reduced spending and increased taxes. They maintained that their approach would be a sounder way to narrow the deficit than either the president's proposals or the mechanism established by the Gramm-Rudman-Hollings Act. The Brookings researchers also spelled out their suggestions for improving the budget process.

Alice M. Rivlin and Charles L. Schultze, two of the authors of *Economic Choices 1987*. The other four authors (not pictured) are Henry J. Aaron, Harvey Galper, Joseph A. Pechman, and George L. Perry.





The Tokyo Summit

Above: From right, Bruce K. MacLaury, Lawrence B. Krause, and Helmut Sonnenfeldt.

BROOKINGS President Bruce K. MacLaury, Senior Fellow Lawrence B. Krause, and Guest Scholar Helmut Sonnenfeldt conducted a news briefing for White House correspondents and other reporters in advance of the economic summit meeting in Tokyo. MacLaury, formerly president of the Federal Reserve Bank of Minnesota, discussed the summit process and the monetary issues on the Tokyo agenda. Krause, a former staff member of the Council of Economic Advisers, focused on trade issues, and Sonnenfeldt, former counselor at the Department of State, explored the political ramifications of the forthcoming talks.

Sonnenfeldt addressing correspondents.



Brookings on the Issues

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